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No. 85-1744

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

WARREN ESSNER,

Petitioner,

—v.—

SECURITIES and EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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April 21, 1986

QUESTION PRESENTED

This petition for certiorari presents the precise question which was reserved in *Rubin v. United States*, 449 U.S. 424, 429 n.6 (1981), and therefore also implicates the continuing viability and precedential weight of *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), the only decision in which this Court has construed the "in connection with" requirement of § 10(b) of the Securities Exchange Act of 1934:

1. Do the antifraud provisions of the federal securities laws apply to misrepresentations which admittedly have nothing to do with the value of the only securities involved in the alleged fraud, and which likewise do not "pertain" to those securities themselves in any other material way?

TABLE OF CONTENTS

	PAGE
Question Presented	i
Table of Authorities	iv
Opinions Below	2
Jurisdiction	2
Statutes and Regulation Involved	2
Statement of the Case	
A. Introduction	3
B. Factual Summary	3
C. Decisions Below	6
Reasons for Granting the Writ	8
Conclusion	19
Appendix	

TABLE OF AUTHORITIES

Cases: PAGE

Angelastro v. Prudential-Bache Securities, Inc., 764 F.2d 939 (3d Cir.), *cert. denied*, 106 S.Ct. 267 (1985) 10

A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967) 18

Brown v. Ivie, 661 F.2d 62 (5th Cir. 1981), *cert. denied*, 455 U.S. 990 (1982) 11

Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir.), *cert. denied*, 105 S.Ct. 253 (1984) .....*passim*

Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811 (2d Cir. 1975) ... 11

Drachman v. Harvey, 453 F.2d 722, (2d Cir. 1972) 12

Drasner v. Thomson McKinnon Securities, Inc., 433 F.Supp. 485, (S.D.N.Y. 1977) 10

Ehrlich-Bober & Co. v. University of Houston, 49 N.Y. 2d, 547, 427 N.Y.S. 2d 604, 404 N.E. 2d 726 (1980). 16

Jannes v. Microwave Communications, Inc., 461 F.2d 525 (7th Cir. 1972) 12

Ketchum v. Green, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977) 10, 11, 12

In re Legel Braswell Government Securities Corp., 648 F.2d 321 (5th Cir. 1981) 16

McGrath v. Zenith Radio Corp., 651 F.2d 458 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981) 11

Miree v. DeKalb, 433 U.S. 25 (1977) 3

Niederhoffer, Cross & Zeckhauser, Inc. v. Telstat Systems, Inc., 436 F.Supp. 180 (S.D.N.Y. 1977) 11

Rubin v. United States, 449 U.S. 424 (1981) .....*passim*

PAGE

SEC v. Miller, 495 F.Supp. 465 (S.D.N.Y 1980) 16

SEC v. Drysdale Securities Corp., et al., 606 F. Supp. 295 (S.D.N.Y. 1985), *rev'd*, No. 85-6111, slip op. (2d Cir. February 21, 1986) .....*passim*

Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974) 10

Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) .....*passim*

Superintendent of Insurance v. Bankers Life & Casualty Co., 430 F.2d 355 (2d Cir. 1970), *aff'g* 300 F.Supp. 1083 (S.D.N.Y. 1969), *rev'd*, 404 U.S. 6 (1971) 9

Trayer v. Karcagi, 476 F.Supp. 1142 (S.D.N.Y. 1979) .. 11

Tully v. Mott Supermarkets Inc., 540 F.2d 187 (3d Cir. 1976) 12

United States v. Erickson, 601 F.2d 296 (7th Cir.), *cert. denied*, 444 U.S. 979 (1979) 16

United States v. Naftalin, 441 U.S. 768 (1979) 18

United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983) 11

United States v. Rubin, 609 F.2d 51 (2d Cir. 1979), *aff'd*, 449 U.S. 424 (1981) 12

Wilson v. First Houston Investment Corp., 566 F.2d 1235 (5th Cir. 1978), *vacated*, 444 U.S. 959 (1979) .. 11

Statutes and Rule:

28 U.S.C. § 1254(1) 2

Securities Act of 1933, 15 U.S.C. §§ 77a-77aa

Section 17(a), 15 U.S.C. § 77q(a) .....*passim*

PAGE

Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk

Section 10(b), 15 U.S.C. § 78j(b) ..... *passim*

Rule 10b-5, 17 C.F.R. § 240.10b-5 ..... *passim*

Other Authorities:

Board of Governors of the Federal Reserve System, Letter to the Presidents of all Federal Reserve Banks, 3 Fed. Banking L. Rep. (CCH) ¶ 35,252 (Apr. 13, 1982) 16

A. Bromberg & L. Lowenfels, *Securities Fraud and Commodity Fraud* (1979) 10

Comptroller of the Currency, Banking Circular 157, 5 Fed. Banking L. Rep. (CCH) ¶ 60,798 (May 13, 1981) 16

House Comm. on Energy and Commerce, Government Securities Act of 1985, H.R. Rep. No. 258, 99th Cong., 1st Sess. (1985) 19

5 A. Jacobs, *Litigation & Practice Under Rule 10b-5* (2d ed. 1981) 10

Securities Exchange Act Release No. 6351, Fed. Sec. L. Rep. (CCH) ¶ 2024 (Sept. 25, 1981) 7

IN THE

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No. _____

WARREN ESSNER,

Petitioner,

—v.—

SECURITIES and EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner Warren Essner respectfully requests that a writ of certiorari issue to review the decision and judgment of the United States Court of Appeals for the Second Circuit dated February 21, 1986, reversing a decision of the United States District Court for the Southern District of New York which had granted petitioner's motion to dismiss an injunctive action brought by the Securities and Exchange Commission (the "Commission") because the Commission's complaint failed to allege facts sufficient to establish fraud "in" or "in connection with" the offer, purchase or sale of securities.

OPINIONS BELOW

The opinion of the court of appeals, *Securities and Exchange Commission v. Drysdale Securities Corp., et al.*, No. 85-6111, slip op. (2d Cir. February 21, 1986), is reprinted in the Appendix at A1-A11.[1] The opinion of the district court is reported at 606 F. Supp. 295 (S.D.N.Y. 1985), and is reprinted in the Appendix at A14-A22. Citations to such opinions are to the relevant page in the Appendix.

JURISDICTION

The decision of the Second Circuit was entered on February 21, 1986. On March 17, 1986, the Second Circuit granted petitioner's motion to stay issuance of the mandate until such time as this Court decided the petition for a writ of certiorari, provided that any such petition be filed by April 21, 1986 (A12-A13).

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATION INVOLVED

The pertinent federal statutes and regulation here are § 17(a) of the Securities Act of 1933 ("the 1933 Act"), 15 U.S.C. § 77q(a), § 10(b) of the Securities Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated by the Securites Exchange Commission under § 10(b), 17 C.F.R. § 240.10b-5. Relevant portions of the statutes and regulation are reprinted in Appendix at A24, A25, and A26, respectively.

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[1] References in the form "A ____" refer to pages of the Appendix to this Petition.

STATEMENT OF THE CASE

A. Introduction

In February 1982, petitioner, a former audit partner of Arthur Andersen & Co. ("Andersen") (A31, ¶ 29), issued a report on the financial condition of a government bond dealer, Drysdale Government Securities, Inc. ("DGSI") (A35-A36, ¶¶ 45-46). It showed initial capital of $20.8 million when DGSI opened its business on February 1, 1982 (A41-A42, ¶ 65(c)).

Between February 1 and May 16, 1982, DGSI engaged in repurchase transactions in government bonds with a number of banks and other dealers which had received a copy of petitioner's report (A37-A39, ¶¶ 52-57).

DGSI collapsed on May 17, 1982, causing large losses to two banks with which it had done business (A40, ¶¶ 59, 61-62).

The Commission thereafter filed a complaint under § 17(a), § 10(b), and Rule 10b-5, even though, as the Commission concedes, DGSI's repurchase agreements were not securities as a matter of law and fact (A21; 606 F. Supp. 299), and also that petitioner made *no* representations—much less misrepresentations—concerning the value of the government bonds involved in those repurchase agreements (A5; A21-A22; 606 F. Supp. 299).

As noted, the question presented by this petition is whether federal jurisdiction exists under § 17(a) of the 1933 Act or § 10(b) of the 1934 Act where the only alleged misrepresentation has to do with general financial condition and does not relate to the value of the bonds or even pertain in any other material way to the bonds involved in the DGSI transactions.

B. Factual Summary[2]

Petitioner was an Andersen audit partner with an expertise in the brokerage industry (A31, ¶ 26). In January 1982, he was

2 Because petitioner's motion was based on the pleadings, the courts below accepted the allegations of the complaint as true. *Miree v. DeKalb*, 433 U.S. 25, 27 (1977) (A3; A14; 606 F.Supp. 295).

engaged to consult with Drysdale Securities Corporation ("DSC"), a broker-dealer registered with the Commission and regulated by the New York Stock Exchange (A29, ¶¶ 9-10).

The consulting assignment related to DSC's plan to transfer its existing business in U.S. government notes, bills and bonds (collectively, "U.S. government bonds") to a new corporation (A34-A35, ¶ 43). Petitioner assembled a team of other Andersen personnel, including one tax partner and two audit employees, who utilized figures supplied by DSC to develop alternative plans of reorganization. The result was DGSI, a new company which opened for business on February 1, 1982 (A34-A35, ¶ 43).

DSC's government bond business had been operated since December 1979 by David J. Heuwetter, who from February 1, 1982 became the principal trader of the new company, DGSI (A32-A34, ¶¶ 34-42).[3] Between December 1979 and January 1982, Heuwetter had adopted the practice of borrowing large quantities of government bonds for DSC through reverse repurchase agreements ("reverse repos") and selling those bonds for cash in the outright market (A33-A34, ¶ 38-40).[4] This trading strategy capitalized upon a pricing convention in the government bond business which treated a repo and an actual sale of a bond differently. In the repo market, the borrower of the bond did not lend cash sufficient to include accrued coupon interest. If coupon interest became due during the term of the repo, the practice was to remit such interest

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3 Heuwetter and two other officers of DSC, Joseph V. Ossorio and Dennis J. Ruppert, were named as defendants in this action. They have consented to entry of permanent injunctions, without admitting or denying the allegations of the complaint. The Commission dropped its action against DSC when the firm was dissolved (A3).

4 A reverse repo is a form of secured lending in which a trading counterpart lends cash and borrows bonds, subject to an agreement to "resell" the same or equivalent bonds at a later date at a fixed "price" calculated to include interest on the cash. A repurchase agreement ("repo") is the same transaction viewed from the perspective of the other party.

immediately to the lender of the bond. In the cash market, bonds were priced to include accrued coupon interest (A33-A34, ¶¶ 38-39).

Heuwetter thereby was able to generate cash for DSC by borrowing bonds through reverse repos and paying cash collateral which did not include an amount equal to accrued coupon interest, while at the same time selling those borrowed bonds in the cash market for a market price which did include an amount equal to accrued coupon interest (A33-A34, ¶ 39). Most of this business involved reverse repos of bonds from three New York banks, Chase Manhattan Bank, N.A. ("Chase"), Manufacturers Hanover Trust Company ("Manufacturers"), and U.S. Trust Company ("U.S. Trust") (A32-A34, ¶¶ 37-39).

DSC allegedly falsified its internal records to reflect these outright sales of government bonds as loans of those bonds to a fictitious entity (A34, ¶ 41). As of January 29, 1982, DSC's books recorded its government bond business as having a net asset value of approximately $3 million when it actually had a deficit of approximately $190 million (A44, ¶ 73). The deficit was allegedly transferred to DGSI when DGSI began business on February 1, 1982 (A37, ¶ 52).

On February 22, 1982, after performing audit work, petitioner issued a document entitled "Drysdale Government Securities, Inc. Statement Of Subordinated Debt And Equity As Of The Opening Of Business On February 1, 1982 Together With Auditors' Report" (the "DGSI Report") (A35-A36, ¶¶ 45-47). DGSI sent the DGSI Report to several banks and government securities dealers with which DGSI did business (A36, ¶ 50).

The DGSI Report showed initial capital of $20.8 million consisting of subordinated debt and equity as of DGSI's opening of business on February 1, 1982 (A41-A42, ¶ 65(c)).

DGSI's business deteriorated between February and May 1982 as U.S. Trust reduced DGSI's positions, Manufacturers required additional collateral from DGSI, and Chase and

others imposed trading limits on DGSI or cut off its business altogether (A38-A40, ¶ 55-58). On May 17, 1982, DGSI collapsed when it was unable to pay approximately $180 million in interest owed to owners of bonds it had borrowed in reverse repos (A40, ¶ 59).

C. Decisions Below

The Commission brought this action in July 1983, seeking permanent injunctive relief against petitioner under § 17(a) of the 1933 Act and § 10(b) of the 1934 Act, and Rule 10b-5 thereunder.[5] The complaint does not charge that petitioner was a conspirator or knowing participant in the fraudulent activity of the DSC and DGSI principals.[6] It also does not allege any misrepresentations about the U.S. government bonds which were involved in DGSI's repo and reverse repo transactions, or about their value. The gist of the complaint is that petitioner misrepresented DGSI's *financial condition* and therefore misled DGSI's bank trading partners concerning its ability to pay coupon interest when due, in breach of its reverse repo agreements.

Upon completion of pre-trial discovery, petitioner moved for dismissal of the complaint for failure to allege a fraud "in connection with" the purchase or sale of a security under § 10(b) or a fraud "in" the offer or sale of a security under § 17(a). The motion was premised on the Commission's con-

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5 A third cause of action seeking injunctive relief for false recordkeeping was asserted against all defendants, except petitioner (A44-45, ¶¶ 72-76).

6 The Commission's interrogatory responses confirm that it does not contend petitioner had actual knowledge of DSC's $190 million deficit or the fraudulent means by which DGSI's initial capital was generated (A56-A57; Commission's Response to Interrogatory No. 7). *See also* Paragraph 51 of the complaint (A36-A37; ¶ 51) which alleges that all defendants, except petitioner,

> . . . knew, should have known or recklessly disregarded the fact that DGSI would be and, in fact, was insolvent as DSC had been on the last business day of January 1982 . . . and that DGSI could meet its obligations only by continuing to open new reverse repo positions and by selling government securities in the outright market to raise additional working capital.

cession that repos are not themselves securities (A21; 606 F. Supp. at 299), so that the only securities involved were genuine U.S. government bonds borrowed or loaned in repo transactions.[7]

After noting that in *Rubin v. United States*, 449 U.S. 424, 429 n.6 (1981), this Court had reserved the issue as to "whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of" the antifraud provisions (A18; 606 F. Supp. at 297), the district court, relying upon Judge Friendly's opinion in *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 105 Sup. Ct. 253 (1984), held that petitioner's alleged misrepresentations of DGSI's financial condition were insufficient by themselves to confer federal jurisdiction because they did not misrepresent the value of the U.S. government bonds or "pertain" to those bonds themselves (A19-A20; 606 F. Supp. at 298; A21-A22; 606 F. Supp. at 299).

The Second Circuit reversed. It held that a misrepresentation of DGSI's financial condition "pertained" to the bonds in question because it was relevant to DGSI's contractual promise to return the same or similar bonds which had been borrowed in reverse repos (A10). Because Judge Friendly had rejected an identical claim in *Chemical Bank* that misrepresentation of the borrower's financial health gave rise to federal jurisdiction because it induced the plaintiff banks to loan money for an illusory promise of repayment, 726 F.2d at 945 (Van Graafeiland, J., dissenting), the panel in petitioner's case was forced to draw a technical distinction between the rights of secured lenders in repos as opposed to conventional bank loans. It concluded, without any real explanation, that "[r]epos differ from traditional collateralized loans in a way that magnifies the importance of Essner's alleged misrepresentations" (A7).

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7 The Commission has flatly stated that "traditional" repurchase agreements of the sort entered into by DGSI are not securities. *See* Securities Exchange Act Release No. 6351, Fed. Sec. L. Rep. (CCH) ¶ 2024 (Sept. 25, 1981) ("the economic realities of traditional repurchase agreements suggest that such agreements are not themselves securities").

REASONS FOR GRANTING THE WRIT

This Court should grant certiorari because this case provides the ideal vehicle for the establishment of a clear and unambiguous jurisdictional standard for lower federal court application of the antifraud provisions of the federal securities laws. Since Justice Douglas' opinion in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), garden variety common law claims have flooded the lower federal courts on the premise that a federal forum was available so long as a security was involved in some manner in a fact pattern which actually evidenced nothing more than common law theft, conversion, breach of contract, or fraud. The result has been confusion and conflict in a case-by-case determination of what actually satisfies the "in connection with" and "in" requirements of § 10(b) and § 17(a).

Ten years after the *Superintendent* decision, this Court itself appeared to draw back from the broad and essentially limitless "touching" test of *Superintendent* when, in a footnote in *Rubin*, it left unanswered the question of whether federal jurisdiction existed in the absence of a misrepresentation which "pertained" to the securities involved in the questioned transactions. That question was answered in the negative in the majority opinion of Judge Friendly of the Second Circuit in *Chemical Bank v. Arthur Andersen & Co.*, *supra*. Now, in petitioner's case, a different panel of the Second Circuit has come to a different conclusion by holding that an alleged misrepresentation of a company's financial condition does confer federal jurisdiction even though, as in *Rubin* and *Chemical Bank*, there is no claim that the statement of financial condition made any misrepresentation regarding the value of the securities involved in the transactions, or even any misrepresentation pertaining in any other way to those securities themselves. Given the conflicting results below, it is apparent that unless this Court addresses this statutory question, the judicial chaos in the lower courts engendered by *Superintendent* can only worsen. Review of the panel's opinion will resolve the tension between *Superintendent* and *Rubin*, and give clarity to this vital issue of federal jurisdiction.

I

Superintendent was a case of theft. The theft was of proceeds received from the sale of government bonds owned by Manhattan Casualty Co. ("Manhattan"), and the scheme involved falsification of Manhattan's records to conceal the diversion, and use of the misappropriated funds to acquire Manhattan's stock. 404 U.S. at 7-9. The Second Circuit found no federal jurisdiction on these facts and affirmed the district court's dismissal of the complaint. *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 430 F.2d 355 (2d Cir. 1970), *aff'g* 300 F. Supp. 1083 (S.D.N.Y. 1969), *rev'd*, 404 U.S. 6 (1971). This Court held otherwise because bonds were involved and because "a fraud or deceit" was practiced on Manhattan, as seller of the bonds, when it "was duped into believing that it, the seller, would receive the proceeds." 404 U.S. at 9.

What was significant in *Superintendent*, and what was a departure from the generally accepted view of the securities laws, was the absence of any misrepresentation bearing on the government bonds. In essence, Justice Douglas transformed a run-of-the-mill theft case into a violation of the federal securities laws because there happened to be securities involved in the theft scheme. He stated:

> Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10(b), whatever might be available as a remedy under state law.

Id. at 12.

The "in connection with" requirement of § 10(b) therefore was said to be satisfied because, in Justice Douglas' words, the "crux" of the case in *Superintendent* was that "Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor." *Id.* at 12-13.

In the wake of *Superintendent*, the lower federal courts construed this "touching" language to expand 10b-5 jurisdiction to virtually any dispute which included an allegation of a fraudulent scheme happening also to involve securities,

regardless of whether there was any misrepresentation regarding the securities themselves or their value. As one commentator has observed:

> The "in connection with" clause would ordinarily be fulfilled if a securities transaction is involved in some way, even though the fraud did not occur in the purchase or sale that is attacked (assuming the fraud and securities transaction can be integrated into the same scheme), the deceit did not concern the terms of the securities transaction, the claimant was not a party to the deceptive transaction, the fraud and the loss were merely indirectly connected, the securities transaction was only tangentially related to the fraudulent course of conduct, and the fraud was not aimed at causing a purchase or sale of a security. As a practical consequence, few cases have found the requisite connection to be lacking.

5 A. Jacobs, *Litigation & Practice Under Rule 10b-5*, § 38.01(b), at 2-43 to 2-44 (2d ed. 1981). *See also* A. Bromberg & L. Lowenfels, *Securities Fraud and Commodity Fraud*, § 4.7(574)(3) at 88.34 (1979) ("By using 'touching' as a synonym, [the Supreme Court] suggested that [the] 'connection' can be very tenuous indeed').

Clearly uneasy with this seemingly limitless view of federal jurisdiction in matters involving securities, the lower courts have treated each set of facts on a case-by-case basis, *see, e.g.*, *Ketchum v. Green*, 557 F.2d 1022, 1027 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974), and, quite predictably, have reached numerous inconsistent results based upon virtually identical fact patterns. *Compare Angelastro v. Prudential-Bache Securities, Inc.*, 764 F.2d 939 (3d Cir.), *cert. denied*, 106 S.Ct. 267 (1985) (misrepresentations concerning interest rates applicable to securities margin accounts held sufficient to confer jurisdiction under § 10(b)) *with Drasner v. Thomson McKinnon Securities, Inc.*, 433 F.Supp. 485, 502-503 (S.D.N.Y. 1977) (Pollack, J.) (alleged failure to require deposits in securities margin account held insufficient

under 10b-5 because margin "had no financial connection with plaintiffs' gains or losses which were solely in conjunction with price movements of the underlying stock"); *compare Wilson v. First Houston Investment Corp.*, 566 F.2d 1235, 1243 (5th Cir. 1978), *vacated on other grounds*, 444 U.S. 959 (1979) (misrepresentations by investment advisor concerning investment advisor's performance held insufficient to sustain jurisdiction under § 10(b)), and *Trayer v. Karcagi*, 476 F. Supp. 1142 (S.D.N.Y. 1979) (no federal cause of action under 10b-5 for misrepresentations by investment advisor relating to his performance) *with Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811 (2d Cir. 1975) (misrepresentation in financial statement relating to investment advisor's past performance held sufficient under §§ 17(a) and 10(b)); *compare Ketchum v. Green*, *supra* (secret plan to oust corporate officers-shareholders and thereby trigger a forced sale of shares for less than market value held insufficient under § 10(b) because scheme was part of "internal corporate conflict") *with Brown v. Ivie*, 661 F.2d 62 (5th Cir. 1981), *cert. denied*, 455 U.S. 990 (1982) (secret plan to oust corporate officer and director, who was 1/3 shareholder in corporation, and thereby cause forced sale of shares for "book value" pursuant to contract held sufficient under 10b-5); *compare McGrath v. Zenith Radio Corp.*, 651 F.2d 458 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981) (misrepresentation in oral agreement concerning intent to retain plaintiff as employee after merger of corporation, in order to induce surrender of stock and option, held sufficient under § 10(b)) *with Niederhoffer, Cross & Zeckhauser, Inc. v. Telstat Systems, Inc.*, 436 F.Supp. 180 (S.D.N.Y. 1977) (failure to compensate plaintiff with securities held insufficient under § 10(b), as there was no fraud relating to particular securities, but only an intention not to comply with contract).[8]

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8 Radically conflicting tests have been enunciated in decisions rendered by different panels of the Second and Third Circuits. In *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983), a panel of the Second Circuit held that the "touching" language suggests that the connection between the fraud and the securities transaction can be "very tenuous indeed." *Id.* at 18. *See also*

II

Ten years later, in *Rubin v. United States*, *supra*, this Court appeared to draw back from and restrict the unlimited jurisdiction which had resulted from the common interpretation of *Superintendent*. *Rubin* was a criminal conviction based upon two types of fraudulent conduct by which the defendant had induced a bank to enter into secured loan transactions with Tri-State Energy, Inc. ("Tri-State"). First, the government charged that Rubin had assisted in the preparation of a misleading statement of Tri-State's financial condition which was submitted to the bank as a prerequisite for even considering a secured lending relationship. *United States v. Rubin*, 609 F.2d 51, 54-55 (2d Cir. 1979), *aff'd*, 449 U.S. 424 (1981). The statement of financial condition falsely portrayed Tri-State as a viable coal operation when, in fact, Tri-State was "experiencing serious financial problems." 449 U.S. at 425; 609 F.2d. at 55. It, however, was sufficient to eliminate "the possibility of the bank's becoming suspicious about the company's available cash." 609 F.2d at 55.

Second, the government charged that Rubin had acted as Tri-State's agent in pledging stock in six companies as collateral for loans from the bank totalling $475,000. Although the pledged stocks were "represented as being good, marketable, and unrestricted and valued at a total of approximately $1.7 million," they were in fact "practically worthless." 449 U.S. at 426.

Jannes v. Microwave Communications, Inc., 461 F.2d 525 (7th Cir. 1972); *Drachman v. Harvey*, 453 F.2d 722, 736, 737 (2d Cir. 1972) (rehearing *en banc* following the Court's decision in *Superintendent of Insurance*). The Third Circuit, on the other hand, has merged the "in connection with" requirement with the concept of causation, thus requiring a more proximate connection between the fraud and the transaction is question. *Ketchum v. Green*, *supra*, 557 F.2d at 1026; *Tully v. Mott Supermarkets Inc.*, 540 F.2d 187, 194 (3d Cir. 1976) ("in connection with" clause "contemplates a causal connection between the alleged fraud and the purchase or sale of stock").

This Court granted certiorari to decide whether a pledge of stock to a bank as collateral for a loan is an "offer or sale" of a security under § 17(a) of the 1933 Act. *Id.* at 425. The Court unanimously determined that Tri-State's pledge of stock, as to which misrepresentations of value were made, was a "sale" within the statutory language, and affirmed the petitioner's conviction.

However, the Court specifically reserved decision on the question of whether Tri-State's false statement of financial condition, which actually induced the bank to make the loans secured by the stock, was sufficient in itself to satisfy the jurisdictional requirements of the federal securities laws:

> The misrepresentations at issue in this case related to the stocks themselves; petitioner does not allege that his conviction, insofar as it involved securities fraud under § 17(a), was based on misrepresentations made about the financial condition of Tri-State itself. Thus, we need not decide whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a).

Id. at 429 n. 6.

The *Rubin* footnote appeared to re-open an issue which would have been readily resolved under the generally prevailing interpretation of *Superintendent*. The Tri-State financials clearly were part of a single fraudulent scheme which involved securities, and quite obviously induced the bank to make a loan which otherwise would not have been made. No clearer case of "touching" can be imagined. Yet *Rubin* specifically declined to decide whether a false statement of financial condition, which said nothing about the value of the pledged securities, was in and of itself sufficient to support federal jurisdiction under the antifraud provisions of the securities laws.

III

Three years later, in *Chemical Bank v. Arthur Andersen & Co.*, *supra*, Judge Friendly of the Second Circuit answered the question posed in *Rubin* "in the negative" by holding that misrepresentation of a borrower's financial condition was not sufficient to confer jurisdiction under either § 10(b) or § 17(a) because the misrepresentation of financial condition did not pertain to the securities pledged as collateral for the loan. 726 F.2d at 943.

In *Chemical Bank*, the plaintiff banks had loaned $15.5 million to Frigitemp Corporation ("Frigitemp") evidenced by promissory notes. In August 1977, the banks and Frigitemp refinanced the loans so Frigitemp could get through the "cash crunch" it was experiencing. 726 F.2d at 933. As a part of that refinancing, the banks made an additional loan of $4 million to Frigitemp's wholly-owned subsidiary, Elsters, Inc. ("Elsters"), evidenced by promissory notes of Elsters. Frigitemp guaranteed payment of the Elsters notes and pledged as security 100% of Elsters common stock. *Id.*

After Frigitemp went into bankruptcy and was unable to pay the loan, the banks sued Andersen alleging violations of the same antifraud provisions at issue in this case. Andersen had audited and reported upon Frigitemp's financial statements, but had made no representations concerning Elsters or its common stock. *Id.* at 943. The banks contended that the pledge of Elsters stock, coupled with Frigitemp's guaranty of the Elsters notes and Andersen's allegedly false statements concerning Frigitemp's financial condition, upon which the banks claimed to have relied, was an integrated scheme sufficient to meet the "in connection with" requirement of § 10(b) and the "in" requirement of § 17(a). *Id.* at 947 (Van Graafeiland, J., dissenting).

Although granting the pledge of the Elsters stock was a purchase and sale of a security, the panel rejected the banks' claims because Andersen's misrepresentations did not pertain to the value of the Elsters stock. *Id.* at 943 at n.22.

Judge Friendly, writing for the majority, posed a particularly relevant example:

> We cannot believe that if a person misrepresents his financial condition in order to borrow $100,000 from a bank to which he gives a one month note partially secured by a pledge of GM stock, the case comes within § 10(b) and Rule 10b-5, although but for the pledge it would not.

Id. at 944.

IV

We come then to the facts of petitioner's case. A certified public accountant, the petitioner reported upon the financial condition of DGSI when it opened for business on February 1, 1982. The statement of financial condition made no representations with regard to the value of the U.S. government bonds which were the subject of DGSI's trading activity. Nor did the statement make any representations which rationally could be said to "pertain" in any other way to those bonds themselves. Relying upon Judge Friendly's determination in *Chemical Bank* of the question left open in the *Rubin* footnote, the district court dismissed the Commission's complaint because "the misrepresentation of DGSI's financial condition did not relate to the value of the government securities upon which the repo market was based" (A21-22; 606 F. Supp. at 299).

The Second Circuit purported to agree in essential respects with the district court's analysis of the controlling case law. But, while it appeared to adopt Judge Friendly's determination of the issue posed in the *Rubin* footnote, a reading of the opinion shows that the panel actually returned to the "touching" test of *Superintendent*, reversed the district court's decision, and thereby reintroduced ambiguity to the appropriate administration of the federal securities laws.

First, the appeals panel, while accepting *Chemical Bank*, distinguished that case by distinguishing repo transactions from collateralized loans. The court stated:

> In the latter transaction [collateralized loans], the lender holds pledged collateral for security and may not sell it in the absence of a default. In contrast, repo "lenders" take title to the securities received and can trade, sell or pledge them. The repo merely imposes a *contractual obligation* to deliver identical securities on the settlement date set by the repo contract.

(A7-A8; emphasis added).

In drawing this distinction, the court ignored the widespread consensus that a repo "is essentially a short-term collateralized loan. . . ." *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980). *See In re Legel Braswell Government Securities Corp.*, 648 F.2d 321, 324 n.5 (5th Cir. 1981); *United States v. Erickson*, 601 F.2d 296, 300 n.4. (7th Cir.), *cert. denied*, 444 U.S. 979 (1979) ("in substance a secured loan"); *Ehrlich-Bober & Co. v. University of Houston*, 49 N.Y. 2d, 574, 577, 427 N.Y.S. 2d 604, 606, 404 N.E. 2d 726 (1980) ("in essence a loan transaction").[9]

The distinction also ignored the critical fact that a lender, like Chemical Bank, ordinarily must remit dividends on pledged stock to the owner of the stock, just as a repo lender, like DGSI, is required to pay coupon interest to the "owner" of the government bonds (A33-A34, ¶ 39). Indeed, in this very case, DGSI collapsed precisely because it was unable to pay such interest (A40, ¶ 59).

Second, in a tortured attempt to make the statement of financial condition in this case appear to "pertain" to the U.S. government bonds, the panel held that the misrepresentation of DGSI's financial condition negated part of the considera-

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9 The same view is held by the Comptroller of the Currency, Banking Circular 157, 5 Fed. Banking L. Rep. (CCH) ¶ 60,798 at 38,856) (May 13, 1981) (A "repo" is, in terms of essential economic realities, a short-term collateralized borrowing), and the Board of Governors of the Federal Reserve System, Letter to the Presidents of all Federal Reserve Banks, 3 Fed. Banking L. Rep. (CCH) ¶ 35,252 at 17,130 (Apr. 13, 1982).

tion which DGSI's bank trading partners expected to receive when they lent bonds to DGSI in traditional repo transactions:

> In both transactions, part of the consideration offered by DGSI was a promise—in repos to repurchase and in reverse repos to resell—that its insolvency rendered worthless. Unlike a pledge of securities in a traditional secured financing, in which the financial health of the lender is irrelevant to the value of both the pledged securities and the pledge itself, DGSI's financial strength was essential to the value received by the other party in a securities transaction.

(A10).

The decision below is simply a disguised application of *Superintendent*'s "touching" test. The panel made no determination that the alleged misrepresentation of DGSI's financial condition related to the value of the U.S. government bonds—which admittedly were exactly what they purported to be—or pertained to those bonds themselves in any other material way. It actually held nothing more than that DGSI's statement of financial condition *affected* the reverse repo transactions as a whole because it purportedly led DGSI's trade partners to believe DGSI would be able to perform its promise to return borrowed bonds and pay coupon interest when due. But this says no more than that the purported misrepresentation of financial condition "touched" DGSI's allegedly fraudulent scheme rather than any securities involved therein. It disregards entirely the question left open by this Court in *Rubin*, *supra*, at p. 13, and thereby transforms an ordinary breach of contract case into a federal securities law violation.

Unless the footnote in *Rubin* is without meaning, and its words "pertaining to the securities themselves" equate with the "touching" test of *Superintendent*, the panel's decision of the petitioner's case is wrong.

The panel's distortion of both *Rubin* and *Chemical Bank* was unsupported even by the cases upon which it relied. In *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), the Second Circuit explicitly recognized that a mere breach of contract would not be actionable; it sustained the federal claims based on the allegation that the purchaser never intended to pay for the securities which it had ordered. 375 F.2d at 398. There is no similar allegation in petitioner's case. DGSI lent money in return for bonds which it borrowed, and both could and did return those bonds by repurchase in the cash market. Its default resulted from an ultimate inability to pay coupon interest as promised (A40, ¶ 59). In *United States v. Naftalin*, 441 U.S. 768 (1979), the misrepresentations went directly to the very existence of the securities. The broker falsely claimed he held the securities and thereby avoided paying the cash margin required by his brokerage counterpart. 441 U.S. at 770. Here, DGSI made no claim of ownership and provided all of the cash collateral required in its repo transactions.

We believe the Second Circuit's legal and factual analysis cannot be supported, eliminates clarity, and returns the question of federal jurisdiction to that impossible gray area engendered by *Superintendent*. Ambiguity on this essential question of federal jurisdiction is unacceptable and must be resolved. If, as in *Superintendent*, federal jurisdiction exists given (a) a fraudulent scheme which (b) happens to involve securities, then this Court should say so. If, however, federal jurisdiction exists only where the alleged fraudulent misrepresentations relate to the intrinsic value of the securities, or at the very least, pertain in a direct, material, and easily identifiable way to those securities themselves, this Court should say so. The inconsistency and chaos which has characterized this important area of federal law since 1971 must be eliminated. A clear definition of federal jurisdiction in matters involving securities must be established. Judges and litigants deserve to know where they stand.[10]

must be established. Judges and litigants deserve to know where they stand.[10]

CONCLUSION

Certiorari should be granted.

Dated: New York, New York
April 21, 1986

Respectfully submitted,

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10 We expect that the Commission will argue that an expansive view of federal jurisdiction is somehow essential to protect the government securities markets. But that is an argument more properly addressed to the Congress which has recently considered legislation granting the Commission certain regulatory powers over participants in the government securities market. *See* House Comm. on Energy and Commerce, Government Securities Act of 1985, H.R. Rep. No. 258, 99th Cong., 1st Sess. (1985).

APPENDIX

TABLE OF CONTENTS

PAGE

Opinion of the United States Court of Appeals for the Second Circuit A-1

Order of the United States Court of Appeals for the Second Circuit granting stay of issuance of its mandate subject to filing of a Petition for Certiorari A-12

Opinion of the United States District Court for the Southern District of New York A-14

Final Judgment of the United States District Court for the Southern District of New York..... A-23

Securities Act of 1933, 15 U.S.C. § 77q(a)..... A-24

Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) ... A-25

Rule 10b-5, 17 C.F.R. § 240.10b-5..... A-26

Plaintiff's Complaint A-27

Plaintiff's Answers to Defendant Essner's First Set of Interrogatories to Plaintiff A-48

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 85—August Term, 1985

(Argued October 24, 1985 Decided February 21, 1986)

Docket No. 85-6111

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

—v.—

DRYSDALE SECURITIES CORPORATION, DAVID J. HEUWETTER, JOSEPH V. OSSORIO, DENNIS J. RUPPERT, WARREN ESSNER,

Defendants,

WARREN ESSNER,

Defendant-Appellee.

Before:

PIERCE, WINTER, and DAVIS,*

Circuit Judges.

* The Honorable Oscar H. Davis, Circuit Judge, United States Court of Appeals for the Federal Circuit, sitting by designation.

Appeal from an order of the United States District Court for the Southern District of New York, Sweet, *J.*, dismissing an action brought to enjoin violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Reversed and remanded.

JACOB H. STILLMAN, Associate General Counsel, Securities and Exchange Commission, Washington, D.C. (Daniel L. Goelzer, General Counsel, Rosalind C. Cohen, Assistant General Counsel, Daniel J. Kraus, Paul Gonson, Securities and Exchange Commission, Washington, D.C., of counsel), *for Plaintiff-Appellant.*

PETER FLEMING, JR., New York, New York (Eliot Lauer, Mark H. O'Donoghue, Bernard V. Preziosi, Jr., Andrew S. Montgomery, Law Clerk, Curtis, Mallet-Prevost, Colt & Mosle, of counsel), *for Defendant-Appellee.*

WINTER, *Circuit Judge:*

The Securities and Exchange Commission ("SEC") appeals from an order of Judge Sweet of the United States District Court for the Southern District of New York dismissing its complaint. The complaint alleged that appellee had violated the antifraud provisions of the federal securities laws. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1985) and Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1982). Holding that the alleged fraud was not in connection with the purchase or sale of a security or in the offer or sale of a security as required respectively by Sections 10(b) and 17(a), Judge Sweet dismissed the complaint on the authority of *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 105 S. Ct. 253 (1984). We reverse.

BACKGROUND

This case arises out of the collapse of Drysdale Securities Corp. ("DSC"), a broker-dealer registered with the SEC, and Drysdale Government Securities, Inc. ("DGSI"). This collapse caused losses to investors of about $300 million. The SEC brought this civil action against DSC, three officers of DSC or DGSI, and Warren Essner, an audit partner at the accounting firm of Arthur Andersen & Co. responsible for the preparation of allegedly false and misleading financial statements for DGSI.[1] For purposes of this appeal, the allegations of the complaint are of course accepted as true.

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1 The SEC dropped its action against DSC when the firm was dissolved. The individual defendants other than Essner have consented to the entry of permanent injunctions without admitting or denying the SEC's allegations.

DSC began its government securities business in or about December, 1979, trading in both the cash or outright market and the so-called "repo" market. In the cash market, DSC sold and purchased government securities from other dealers. In the repo market, which involves the transactions pertinent to the present case, DSC engaged in sale and repurchase agreements ("repos"), which were structured as sales of securities by DSC subject to an agreement by DSC to repurchase them from the other party at a fixed price at a later date. Under reverse sale and purchase agreements ("reverse repos"), DSC purchased government securities subject to an agreement to resell them to the other party at a fixed price at a later date. A repo and reverse repo are thus descriptions of the same transaction viewed from different sides.

In January, 1982, Essner was retained by DSC to assist in the spin-off of its government securities business. He prepared a plan to transfer this business to DGSI, which DSC implemented later that month. DSC sent a letter to banks and securities dealers on February 1 announcing the formation of DGSI. This letter stated that DGSI's capital was $20.8 million. It is alleged that DGSI actually had a deficit of $190 million that it inherited along with the government securities business from DSC. When the letter failed to produce the volume of business for which DGSI had hoped, Essner was asked to prepare a more formal document to give DGSI more credibility. Accordingly, Essner, on behalf of Arthur Andersen, prepared a certified statement of DGSI's subordinated debt and equity, accompanied by an unqualified audit opinion.

According to the complaint, Essner's preparation of these reports violated generally accepted auditing standards and/or internal Arthur Andersen procedures by

failing to examine certain records, to investigate the "related party nature" of certain transactions, and to have a person outside his audit team check the final report against work papers. The report, issued on February 22 and dated February 1, again failed to disclose the capital deficit or that $15.8 million of DGSI's capital was loaned to it by DSC, of which $12 million was repaid shortly after DGSI opened for business on or about February 1. Essner knew that the documents he prepared would be used by DGSI to induce customers to do business with it.

DISCUSSION

The precise legal issue before us is whether the fraud alleged is either in connection with the purchase or sale of a security, as required by Section 10(b), or in the offer or sale of a security, as required by Section 17(a). This issue arises because there is no allegation that DGSI or Essner misled investors with respect to the value of the government securities traded by DGSI rather than with respect to DGSI's financial health. Judge Sweet viewed repos as indistinguishable from collateralized loans and thus held that our recent decision in *Chemical Bank* controlled the outcome. We disagree.

In *Chemical Bank*, Frigitemp, a publicly held company, entered into a secured financing agreement with various banks in 1975, including Chemical. In this transaction, the banks provided Frigitemp with an $8 million line of credit and took a security interest in Frigitemp's customer notes receivables. Within a year, it became clear that Frigitemp would need to restructure its debt. A restructuring took place in August, 1977 pursuant to which the

maturity dates of certain notes issued under the secured credit agreement were extended, certain unsecured notes were replaced with other unsecured notes, and $4 million in fresh cash was advanced to Elsters, a wholly-owned Frigitemp subsidiary. In exchange for the advance to Elsters, the banks received Elsters' promissory notes, which were guaranteed by Frigitemp, and a pledge by Frigitemp of 100% of Elsters' common stock as security. Frigitemp filed a petition in bankruptcy in March, 1978. The banks, holding substantial unpaid Frigitemp loans, sued three of Frigitemp's principal officers and Arthur Andersen, Frigitemp's auditor. The banks claimed that Arthur Andersen knew that Frigitemp had submitted false and misleading financial statements in order to obtain financing, and that these misrepresentations were in connection with the pledge of the Elsters stock for purpose of the antifraud provisions.

We held that the pledge of the Elsters stock was a purchase and sale of a security for the purposes of Section 10(b) on the authority of *Mallis v. Federal Deposit Insurance Corp.*, 568 F.2d 824 (2d Cir.), *cert. granted*, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381 (1978). We also held, however, that misrepresentations regarding the financial health of Frigitemp could not form the basis of a violation of Section 17(a), Section 10(b), or Rule 10b-5 despite the fact that Frigitemp had pledged securities in order to procure the advance for Elster. Judge Friendly's opinion noted:

> Andersen is not alleged to have deceived the Banks with respect to the pledge of the Elsters stock; the Banks got exactly what they expected . . . . The Act and Rule impose liability for a proscribed act in

> connection with the purchase or sale of a security; it is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the pledge of a security is a part.

Chemical Bank, 726 F.2d at 943.

In our view, the instant case is distinguishable. Repos differ from traditional collateralized loans in a way that magnifies the importance of Essner's alleged misrepresentations.[2] Moreover, such misrepresentations directly involve the consideration for a securities transaction and are thus closely linked to transfers of securities, unlike the misrepresentation in *Chemical Bank*.

Essner attempts to fit the present case within the rationale of *Chemical Bank* by characterizing a repo as a short-term, collateralized loan. In Essner's view, when DGSI engaged in a repo transaction, it borrowed cash, delivered the securities as collateral, and agreed to pay off the loan with interest by repurchasing the securities at a fixed price. Essner thus states:

> That the parties were obliged to repay and redeliver at the end of the transactions was no more a part of the consideration and no different in kind than the normal obligations of any lender to release security upon repayment of debt or of any borrower to repay cash debt.

(Brief of Appellee at 25-26) (footnote omitted).

Essner ignores a most significant difference between repos and standard collateralized loans, however. In the

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[2] The SEC does not contend in this case that repos or reverse repos are securities within the meaning of the relevant legislation. Our discussion is based on the assumption that they are not.

latter transaction, the lender holds pledged collateral for security and may not sell it in the absence of a default. In contrast, repo "lenders" take title to the securities received and can trade, sell or pledge them. The repo merely imposes a contractual obligation to deliver identical securities on the settlement date set by the repo contract. Unlike the lender in *Chemical Bank*, therefore, the secured "lender" in a repo is free to deal the "collateral."

This difference between repos and ordinary secured loans plainly magnifies the importance of the financial position of the parties, and thus of Essner's alleged misrepresentations, in a way directly affecting the transaction in securities. In this respect, the instant case closely resembles *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), and *United States v. Naftalin*, 441 U.S. 768 (1979). In *Brod*, we held that a scheme of placing purchase orders for securities with the intent of paying for them only if they had appreciated by settlement date was actionable under Section 10(b). In *Naftalin*, the Supreme Court found Section 17(a) liability for the flip side of *Brod*. In that case, a broker placed sell orders for shares he did not own with the hope of profiting by purchasing them at a price below the price of his sale. When, prior to settlement, the prices of the "sold" shares rose sharply, Naftalin's undisclosed scheme collapsed.

The scheme in which Essner is alleged to be a party closely resembles those held actionable in *Brod* and *Naftalin*. When DGSI engaged in a repo, it agreed to repurchase securities at a fixed price at a later date. Given its alleged insolvency from birth, its ability to make good on this agreement was more dependent upon the appreciation of the underlying securities than it would have been

had it been financially healthy. Similarly, in a reverse repo, DGSI's ability to honor its obligation to resell securities depended upon its financial health since its common practice, like that of typical government securities dealers, was to sell immediately the securities received in a reverse repo either for cash or in another repo. Thus, in order to resell the securities upon settlement date of a reverse repo, DGSI had to purchase identical securities, something which its insolvency may have rendered impossible.[3] Even if it did not resell immediately, the securities held by DGSI were DGSI assets available for satisfaction of its debts and thus could be seized by creditors, an eventuality directly related to DGSI's financial condition. Repos are thus critically different from the secured loans involved in *Chemical Bank*.

Moreover, *Chemical Bank* states that fraud pertaining to the consideration in a securities transaction is in connection with that transaction. Specifically, *Chemical Bank* states:

> The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are

[3] According to the complaint, DGSI was able to stay afloat for the less than four months of its operation by exploiting a pricing difference between the cash and repo markets. In the cash market, a purchaser was required to pay the accrued coupon interest on a security as a part of the purchase price, whereas in a reverse repo, a purchaser did not pay for this accrued interest but instead remitted the interest to the seller when the coupon matured. Therefore, DGSI was able to stay afloat by continually acquiring securities at something of a discount via reverse repos, and selling them immediately in the cash market for a price that included accrued coupon interest income. DGSI's reverse repo positions exceeded its repo positions by about $1 billion to $2 billion and, when its reverse repo customers reduced their positions, the firm collapsed.

> not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.

726 F.2d at 943.

Essner's misrepresentation clearly pertained to a significant part of the consideration offered by DGSI in repos and reverse repos. In both transactions, part of the consideration offered by DGSI was a promise—in repos to repurchase and in reverse repos to resell—that its insolvency rendered worthless. Unlike a pledge of securities in a traditional secured financing, in which the financial health of the lender is irrelevant to the value of both the pledged securities and the pledge itself, DGSI's financial strength was essential to the value received by the other party in a securities transaction.

In addition, Judge Friendly's discussion in *Chemical Bank* of *Weaver v. Marine Bank*, 637 F.2d 157, 159-60 (3d Cir. 1980), *rev'd on other grounds*, 455 U.S. 551 (1982), supports the view that the former decision does not control this case. 726 F.2d at 944. In *Weaver*, plaintiffs pledged a bank certificate of deposit ("CD") to the bank as security for their guaranty of the debt of a third party. Plaintiffs claimed that the bank misrepresented the financial condition of the third party in procuring this guaranty and pledge. The third circuit, holding the CD to be a security,[4] decided that the bank's misrepresentations were in connection with the pledge of the CD and thus actionable under Section 10(b).

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[4] This part of the decision was later reversed by the Supreme Court. *See* 455 U.S. 551, 556-59 (1982).

Chemical Bank distinguished *Weaver*, noting that the misrepresentations in *Weaver* induced the pledge, whereas the misrepresentations in *Chemical Bank* induced the banks to make a loan collateralized in part by a pledge. 726 F.2d at 944. The distinction is that in *Weaver*, as in the instant case, securities were transferred as a direct result of a misrepresentation, whereas in *Chemical Bank* the direct result of the misrepresentations was a loan and not a securities transfer.

Reversed and remanded.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket No. 85-6111

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellant,

—against—

DRYSDALE SECURITIES CORP., et al.,
Defendants,

WARREN ESSNER,
Defendant-Appellee.

NOTICE OF MOTION
for Stay of Issuance of the Mandate

MOTION BY: Curtis, Mallet-Prevost, Colt & Mosle
(212) 696-6000
Peter Fleming Jr.

OPPOSING COUNSEL: Securities and Exchange Commission
(212) 264-1603
Jason R. Gettinger

Has consent of opposing counsel:	
A. been sought?	No
B. been obtained?	No
Has service been effected?	Yes
Is oral argument desired? (substantive motions only)	No

Has argument date of appeal been set:

A. by scheduling order? N/A
B. by firm date of argument notice? N/A
C. If Yes, enter date: *Appeal argued 10/24/85*

Brief statement of the relief requested:

Order staying the issuance of the mandate pending the filing by Defendant-Appellee Warren Essner of a petition for a writ of certiorari in the Supreme Court.

By: /s/ PETER FLEMING JR.
Peter Fleming Jr.
Attorney for Defendant-Appellee
Warren Essner

March 11, 1986

United States Court of Appeals
Second Circuit
FILED
MAR 11 1986
Elaine B. Goldsmith, Clerk

ORDER

IT IS HEREBY ORDERED that the motion is granted and issuance of the mandate will be stayed until such time as the Supreme Court decides upon the petition for writ of certiorari. This stay is conditioned upon the filing of said petition by April 21, 1986.

/s/ LAWRENCE W. PIERCE
Circuit Judge

/s/ RALPH WINTER
Circuit Judge

March 17, 1986

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

No. 83 Civ. 5599 (RWS)

March 22, 1985

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff,

—v.—

DRYSDALE SECURITIES CORPORATION, et al.,
Defendants.

OPINION

SWEET, *District Judge*.

Defendant Warren Essner ("Essner") has brought this motion to dismiss the complaint of the plaintiff Securities and Exchange Commission ("SEC") pursuant to Fed.R.Civ.P. 12(b)(1) and 12(b)(6) relying upon the Second Circuit's recent decision in *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, ____ U.S. ____, 105 S.Ct. 253, 83 L.Ed.2d 190 (1984). The motion is granted.

The Complaint

The SEC brought this action against Essner arising out of his participation in a fraud which resulted in the collapse of Drysdale Government Securities, Inc. ("DGSI"), and losses to investors of about $290 million. The allegations in the complaint, described below, are accepted as true for the purposes of deciding this motion to dismiss. *Miree v. DeKalb*, 433 U.S. 25, 27, 97 S.Ct. 2490, 2492, 53 L.Ed.2d 557 (1977).

Drysdale Securities Corporation ("DSC"), a broker-dealer registered with the SEC and regulated by the New York Stock Exchange, operated a business in U.S. Government obligations including United States treasury bonds, notes and bills. From December 1979 to February 1982, DSC's government securities business was conducted by David Heuwetter. This operation was taken over by DGSI, a newly formed corporation, as of January 31, 1982, and was continued by DGSI under Heuwetter's direction until May 17, 1982 when DGSI defaulted on payments of over $160 million in accrued coupon interest obligations. (Complaint at ¶¶ 31-32).

This default occurred as a consequence of DGSI's repurchase and reverse repurchase agreements in what is called the "repo" market in U.S. Government obligations. (Complaint at ¶ 42). In its repurchase agreements, DGSI loaned U.S. government obligations to third parties in return for cash. These agreements provided that DGSI would repay the cash, with interest, at a specified date, and that the third parties would return the same or similar U.S. government obligations. Ownership of the U.S. government obligations did not change, and the owners remained entitled to all coupon interest which accrued during the term of the agreements. (Complaint at ¶¶ 34-39).

In its reverse repurchase agreements, DGSI borrowed U.S. government obligations from third parties and loaned cash in return. DGSI was obligated to return the same or similar U.S government obligations at a specified date, and the third party was required to repay the cash, with interest, to DGSI. Again, ownership of the U.S. government obligations did not change, and the owner remained entitled to coupon interest which accrued during the term of the agreements. (Complaint at ¶ 39). *See generally SEC v. Miller*, 495 F.Supp. 465 (S.D.N.Y. 1980).

DGSI followed the earlier practice of DSC, generating working capital for its government securities business by taking advantage of prevailing pricing practices in the government securities markets. At that time, the purchaser of a government

security in a reverse repo transaction did not pay the seller accrued coupon interest as part of the purchase price but remitted it when the coupon matured. In contrast, the purchaser of a government security in the cash or outright market was required to pay the accrued interest as part of the purchase price (Complaint at ¶ 39). This disparity enabled DGSI to obtain securities through reverse repos, sell them to dealers in the outright market, and immediately realize the accrued interest. Using this strategy, DGSI had use of the interest until the coupon payment dates. However, once the securities were sold outright, DGSI had to purchase securities in the cash market in order to redeliver them to the reverse repo sellers at the close of the transaction. (Complaint ¶¶ 37-39, 53).

DGSI carried out these operations on a massive scale, its daily cash transactions amounted to over $100 million (Complaint ¶ 53), and DGSI's ability to carry out commitments to its trading partners depended on continually opening new reverse repo positions and selling the government securities thus acquired. (Complaint ¶¶ 42, 51, 53). When its reverse repo partners cut back on the open positions maintained with DGSI (Complaint ¶ 55), the firm collapsed.

In January 1982, Essner, an audit partner at the accounting firm of Arthur Andersen & Co., was retained by DSC to assist in the spin-off of its government securities business (Complaint ¶¶ 26, 43). Essner proposed a plan, which DSC implemented, to transfer DSC's government securities business to DGSI. (Complaint at ¶ 43). At the request of DSC's chairman of the board, Essner drafted a letter for distribution to various government securities dealers and banks, announcing DGSI's formation and representing its capital as $20.8 million. (Complaint ¶¶ 44, 65). In fact, DGSI inherited from DSC its positions in government securities carrying with them a deficit of approximately $190 million. (Complaint at ¶¶ 40, 43, 52, 65).

To give DGSI greater credibility, Essner prepared, on behalf of Arthur Andersen, a certified statement of DGSI's subordinated debt and equity, accompanied by an unqualified audit

opinion representing that the examination of DGSI's subordinated debt and equity had been made in accordance with generally accepted auditing standards. (Complaint at ¶¶ 45-48). In addition to repeating the representation that DGSI had capital of $20.8 million, the report materially misstated the net fair value of significant operating assets and liabilities which ostensibly had been transferred to DGSI in exchange for preferred stock. (Complaint at ¶¶ 48, 65). The report, issued on February 22, 1982, and dated February 1, did not disclose that $15.8 million of DGSI's capital was in fact loaned indirectly to it by DSC, and that on February 1, after DGSI opened for business, it transferred at least $12 million of these funds back to DSC. (Complaint at ¶¶ 49, 65(c)(3)). Essner knew that DGSI would use these documents to induce securities dealers and banks to engage in government securities transactions. (Complaint at ¶ 50).

Conclusions

The SEC alleges that Essner's acts constitute violations of § 17(a) of the Securities Act, 15 U.S.C. § 77q(a) and Section 10(b) of the Exchange, 15 U.S.C § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. These provisions make it unlawful to engage in fraudulent conduct "in connection with the purchase or sale of a security."[1] The issue that must be resolved here, in light of *Chemical Bank*, *supra*, is whether Essner's alleged misrepresentations with respect to DGSI's financial condition, but not with respect to the Government securities involved in the repo and reverse repo transactions, are "in connection with" the purchase or sale of a security. If the complaint does not satisfy the "in connection

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1 The parties agree that the "in connection with" requirement of § 10(b) is indistinguishable in substance from § 17(a)'s requirement that the fraud be "in" the offer or sale of securities. *United States v. Naftalin*, 441 U.S. 768, 773 n. 4, 99 S.Ct. 2077, 2081 n. 4, 60 L.Ed.2d 624 (1979); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir.), *cert. denied*, ___ U.S. ___, 105 S.Ct. 253, 83 L.Ed.2d 190 (1984).

with" requirement, no cause of action under either § 17(a) or § 10(b) has been alleged, and the complaint must be dismissed.

The Honorable Henry J. Friendly, in *Chemical Bank*, *supra*, confronted the issue reserved by the Supreme Court in *Rubin v. United States*, 449 U.S. 424, 429 n. 6, 101 S.Ct. 698, 701, n. 6, 66 L.Ed.2d 633 (1981), namely "whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a)." *Id.* Judge Friendly concluded that they did not. That decision controls the result here.

In *Chemical Bank* plaintiff Chemical Bank and three other commercial banks had loaned $15.5 million to Frigitemp Corporation in a series of transactions from late 1975 to early 1977. In August 1977, the banks and Frigitemp executed a refinancing transaction which included a loan of $4 million to Frigitemp's wholly-owned subsidiary, Elsters, Inc., for which the banks received promissory notes of Elsters. Frigitemp guaranteed the notes and pledged as security 100% of Elster's common stock. This pledge constituted a sale and purchase under § 10(b). *Chemical Bank* at 939; *Mallis v. Federal Deposit Insurance Corp.*, 568 F.2d 824, 830 (2d Cir. 1977), *cert. dismissed*, 435 U.S. 381, 98 S.Ct. 1117, 55 L.Ed.2d 357 (1978). In March 1978, Frigitemp filed a petition in bankruptcy. The banks sued Andersen and three Frigitemp officers, alleging violations of § 10(b), Rule 10b-5, and § 17(a). Although Andersen had audited and reported upon Frigitemp's financial statements for the years 1973-76, Andersen had made no representations concerning Elsters or the value of its stock. The banks contended that but for the Frigitemp financial statements, which were prepared by Andersen, and were alleged to be false and misleading, the banks would not have entered into the loan transaction with Elster, which included the pledge of Elsters' stock. The banks argued further that the misrepresentations with respect to Frigitemp affected the entire Elsters transaction because Frigitemp's guarantee was less valuable than the banks had been made to believe and the banks would consequently have to rely more heavily on the pledge of Elsters' stock.

Judge Friendly held that the banks' showing that but for Andersen's description of Frigitemp the banks would not have renewed the Frigitemp loans or made the Elsters loan, which led to the pledge of Elsters' stock, was insufficient to satisfy the "in connection with" requirement. *Chemical Bank* at 943. Because Andersen's misrepresentation related to Frigitemp, and not the securities involved in the transaction, the pledged Elsters' stock, the "in connection with" requirement was not satisfied. The opinion explained:

> The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be. Andersen is not alleged to have deceived the Banks with respect to the pledge of the Elsters stock; the Banks got exactly what they expected. Their showing is simply that but for Andersen's description of Frigitemp they would not have renewed the Frigitemp loans or made the Elsters loan which Frigitemp guaranteed, and, that if they had not done this, there would have been no pledge of Elsters' stock. Such "but-for" causation is not enough. The Act and Rule impose liability for a proscribed act in connection with the purchase or sale of a security; it is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the pledge of a security is a part.

Id.

In this case as well, the alleged misrepresentations by Essner and Andersen related to the capitalization of DGSI, not to the value of the government securities underlying the "repo" market or the financial stability of the issuer. Moreover, to the extent that Andersen's misrepresentations of Frigitemp's financial condition in *Chemical Bank* were indirectly relevant

to the financial condition of Frigitemp's wholly-owned subsidiary, Elsters, and consequently the value of Elsters' stock, *see Chemical Bank* at 947 (Van Graafeiland, J. dissenting), Essner's report is that much more remote from the securities in this case. DGSI clearly has no such comparable relationship with the U.S. government.

The SEC relies, however, on *Competitive Assoc. Inc. v. Laventhol, K.H. & H.*, 516 F.2d 811 (2d Cir. 1975), which was not expressly overruled by *Chemical Bank*, but was denied much of its precedential value by the reasoning and result of *Chemical Bank*. In *Competitive Assoc.*, Competitive Associates, ("Associates") a publicly held mutual fund, alleged that Laventhol, Krekstein, Horwath and Horwath ("Laventhol"), an accounting firm, in furtherance of a fraudulent scheme to induce Associates to retain Akiyoshi Yamada ("Yamada") and Takara Asset Management as managers of a part of Associate's portfolio, knowingly certified false and misleading financial statements of Takara Partners, a private investment fund managed by Yamada. As a result, Associates subsequently lost several million dollars from purchases and sales of securities which Yamada made, in his capacity as advisor. Associates alleged that the investment performance of Takara Partners was the primary criterion by which Yamada's expertise as an investment advisor was gauged and that the statements certified by Laventhol were materially false and misleading with respect to Takara's performance. Further, Associates alleged that Laventhol knowingly and with intent to defraud certified these statements in order to aid Yamada in attracting customers, thereby also creating a market for securities which Takara was manipulating. The court found on these facts that the "in connection with" requirement was satisfied, holding that:

> The "in connection with" requirement has been broadly interpreted by the Supreme Court to require only that plaintiff shall have "suffered an injury as a result of deceptive practices touching its sale of securities as an

> investor." *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6, 12-13, 92 S.Ct. 165, 169, 30 L.Ed.2d 128 (1971). The broad "touch" test enunciated in *Bankers Life* is certainly met by plaintiff's allegations that the very purpose of defendants' certification of Takara's financial statement was to aid in placing Yamada in a position where he could manipulate securities prices and sell these securities to investors attracted by Yamada's reputation and performance . . . [P]laintiff here alleges that the accountants accepted payoffs and otherwise actively collaborated with Yamada for the specific purpose of influencing investors to authorize Yamada *to carry out security transactions on its behalf*.

Id. at 815 (emphasis supplied).

The court in *Chemical Bank* distinguished *Competitive Associates* because it involved "misrepresentation by an accounting firm with respect to an investment fund through which plaintiff intended to and did engage in massive trading in securities." However, the opinion in *Chemical Bank*, does not focus on the fact that the misrepresentations in *Competitive Associates* did not relate to the securities involved thereafter in the securities transactions. Moreover, *Competitive Associates* appears to rely upon the "but for" causation rejected in *Chemical Bank*.

Whether or not the proposition that the cases can be distinguished is accepted, the facts now before this court are closer to *Chemical Bank* than *Competitive Associates*. Repos and reverse repos have been conceded by the SEC not themselves to constitute securities, and the SEC has not altered its position in this case. (*See* Reply Mem. of Def. Essner, p. 2). The contact between the misrepresentation and the "massive" securities transactions that the court found in *Competitive Assoc.* is thus more direct than in the facts here. Whether or not the repos are characterized as loans merely collateralized by government securities, as Essner argues in order to make the facts of this case more parallel to those of *Chemical Bank*, the misrepresentation of DGSI's financial condition did not relate to the value

of the government securities upon which the repo market was based. However, only by relying on the "but for" causation specifically rejected in *Chemical Bank*, which in my view effectively overruled the reasoning of *Competitive Associates*, could I find the "in connection with" requirement satisfied here.

SEC argues that *Chemical Bank* is distinguishable because that case arose from "a conventional lending relationship" with respect to which the pledge of Elsters stock was "merely an incident in a transaction not otherwise involving the purchase or sale of securities," *Chemical Bank* at 944 n. 24. The reasoning in *Chemical Bank*, however, hinged not on the degree to which the entire transaction involved securities, but rather on the extent to which the alleged misrepresentation was linked to the securities which were involved in the transaction. The linked misrepresentation is less direct here, and the motion is therefore granted as required by the holding of *Chemical Bank*.

The case is dismissed, and the clerk is directed to enter judgment.

IT IS SO ORDERED.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

83 CIVIL 5599 RWS

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

—against—

DRYSDALE SECURITIES CORP., ET AL.,

Defendants.

FINAL JUDGMENT

Defendant Warren Essner having moved pursuant to Fed. R. Civ. P. 12(b)(1) and 12(b)(6), to dismiss the complaint and the said motion having come before the Honorable Robert W. Sweet, U.S.D.J., and the Court thereafter on March 25, 1985, having handed down its opinion (#57409), dismissing the case and directing the Clerk to enter judgment, it is,

ORDERED, ADJUDGED AND DECREED: That the complaint be and it is hereby dismissed.

/s/ RAYMOND F. BURGHARDT
Clerk

DATED: NEW YORK, N.Y.
March 28, 1985

THIS DOCUMENT WAS ENTERED ON THE
DOCKET ON 3-29-85

SECURITIES ACT OF 1933

15 U.S.C. § 77q(a)

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

SECURITIES EXCHANGE ACT OF 1934

15 U.S.C. § 78j(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

RULE 10b-5

17 C.F.R. § 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

83 Civil 5599 (RWS)

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff,

—against—

DRYSDALE SECURITIES CORPORATION, DAVID J. HEUWETTER, JOSEPH V. OSSORIO, DENNIS J. RUPPERT, WARREN ESSNER,
Defendants.

Plaintiff Securities and Exchange Commission ("Commission") alleges that:

1. This action seeks injunctive and other equitable relief against Drysdale Securities Corporation ("DSC"), David J. Heuwetter ("Heuwetter"), Joseph V. Ossorio ("Ossorio"), Dennis J. Ruppert ("Ruppert") and Warren A. Essner ("Essner") because they have committed or aided and abetted securities fraud, because DSC, aided and abetted by Heuwetter, Ossorio and Ruppert, has kept false and incomplete books and records and because such persons will again commit or aid and abet such violations of the federal securities laws, unless enjoined. To wit:

2. Defendants DSC, Heuwetter, Ossorio, Ruppert and Essner have engaged and are about to engage in acts, practices and courses of business which constitute violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a) and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule

10b-5 thereunder, 17 C.F.R. § 240.10b-5 (anti-fraud provisions).

3. Defendant DSC has engaged and is about to engage in acts, practices and courses of business and defendants Heuwetter, Ossorio and Ruppert have aided and abetted or are about to aid and abet such acts, practices and courses of business which constitute and will constitute violations of Section 17(a) (1) of the Exchange Act, 15 U.S.C. 78q(a) and Rules 17a-3(a) (2), 17a-3(a) (4) (C) and 17a-3(a) (5), 17 C.F.R. § 240.17a-3 (record keeping provisions).

JURISDICTION AND VENUE

4. The Commission is authorized to bring this action under Section 20(b) of the Securities Act, 15 U.S.C. § 77t(b) and Sections 21(d) and 21(e) of the Exchange Act, 15 U.S.C. §§ 78u(d), 78u(e).

5. This Court has jurisdiction over this action under Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a) and Section 27 of the Exchange Act, 15 U.S.C. § 78aa.

6. Pursuant to Sections 10(b), 17(a) and 23(a) of the Exchange Act, 15 U.S.C. §§ 78j(b), 78q(a) and 78u(a), the Commission has promulgated Rules 10b-5, C.F.R. § 240.10b-5 and 17a-3, 17 C.F.R. § 240.17a-3, which were in effect at all material times and remain in effect.

7. In connection with the acts and practices alleged in this complaint, the defendants, directly and indirectly, made use of the means and instruments of transportation or communication in, and the means or instrumentalities of, interstate commerce, or the mails.

8. Venue is properly laid in this district because the acts and practices constituting the alleged securities law violations occurred primarily in this district and the defendants have or had their principal places of business here.

DESCRIPTION OF DEFENDANTS

Drysdale Securities Corporation ("DSC")

9. DSC, a Delaware corporation, is a broker-dealer registered with the Commission since March 1, 1976.

10. Prior to June 15, 1982, DSC was a member firm of the New York Stock Exchange and conducted operations in equities, options, municipal and other fixed income securities, as well as government securities including United States treasury bonds, notes and bills ("government securities"). DSC withdrew its NYSE membership on June 15, 1982, after ceasing public business and transferring customer accounts to two clearing firms.

11. DSC's current address is 11 Broadway, New York, New York. During 1981 and 1982, DSC was at various times located at 55 Water Street, 61 Broadway, and 65 Liberty Street, all in New York, New York.

Joseph V. Ossorio ("Ossorio")

12. Ossorio is, and at all relevant times was, the Chairman of the Board of Directors and Chief Executive Officer of DSC. He directed and caused the direction of DSC's management and policies. Among his responsibilities were supervision of the other officers and the firm's day-to-day operations, including government securities trading.

13. Ossorio formulated and implemented a plan to establish Drysdale Government Securities, Inc. ("DGSI") and served as a DGSI director from February 1982 to May 1982.

14. On March 31, 1983, Ossorio pled guilty to a three count information brought by the United States Attorney for the Southern District of New York charging violations of Rule 10b-5 for his mismanagement of certain customer accounts at DSC.

15. On April 15, 1983, in an initial decision by the New York Stock Exchange ("NYSE"), Ossorio was barred from association with any NYSE member.

16. Ossorio resides at 60 Lismore Lane, Greenwich, Connecticut.

David J. Heuwetter ("Heuwetter")

17. From in or about December, 1979 to February 1982, Heuwetter traded government securities at DSC, reporting directly to Ossorio. Together with Dennis J. Ruppert he was directly and indirectly responsible for reflecting DSC's government securities positions on its books and records.

18. From February 1982 to May 17, 1982, Heuwetter was DGSI's Treasurer and led its government trading operations. Also, he owned all of DGSI's common stock and held its subordinated debt.

19. Heuwetter is currently trading in the futures market.

20. Heuwetter resides at 363 East 76 Street, New York, New York.

Dennis J. Ruppert ("Ruppert")

21. Ruppert joined DSC in April 1978 and at all relevant times was DSC's Treasurer and Controller, reporting to Ossorio.

22. During the relevant period, he maintained DSC's books and records and controlled DSC's bank accounts. Ruppert also controlled DGSI's government securities clearing account.

23. Ruppert remained employed by DSC until his termination on June 3, 1983.

24. Ruppert resides in Teaneck, New Jersey.

Warren Essner ("Essner")

25. Essner is, and at all relevant times was, a certified public accountant, licensed by the State of New York.

26. During the relevant period Essner was an audit partner specializing in the securities industry at Arthur Andersen & Co., a national public accounting firm.

27. In January 1982 Essner led a consulting team of Andersen personnel that aided DSC in formulating a plan to establish DGSI.

28. On or about February 22, 1982 pursuant to a purported audit, Essner authorized and caused Arthur Andersen & Co. to issue a certified statement of subordinated debt and equity for DGSI ("the Essner Report").

29. Essner resigned from Arthur Andersen & Co. effective June 30, 1983.

30. Essner resides in Garden City, New York.

DESCRIPTION OF RELATED PERSONS AND ENTITIES

Drysdale Government Securities, Inc. ("DGSI")

31. DGSI, an unregistered government securities dealer, was incorporated in Delaware on September 9, 1981 but remained dormant until activated on or about February 1, 1982, when under Heuwetter's direction, it began government securities activities Heuwetter formerly conducted at DSC.

32. DGSI failed on May 17, 1982 when it defaulted on payments of over $160 million in accrued coupon interest owed to entities with whom it had open reverse repurchase agreements in government securities. Its assets and liabilities were assumed by the Chase Manhattan Bank, N.A. pursuant to an agreement reached on or about May 19, 1982.

33. DGSI's offices were located in Manhattan, first at DSC's 61 Broadway office and then at 65 Liberty Street

together with DSC's municipal bond and operations departments. DGSI currently has no office.

BACKGROUND

Government Securities Transactions at DSC

34. In or about December 1979, Heuwetter began to engage in transactions in government securities on behalf of DSC.

35. Heuwetter's government securities transactions on behalf of DSC occurred in two distinct markets, namely, the cash or outright market and the so-called repo market:

(a) in the cash market he purchased and sold government securities in transactions with other securities dealers;

(b) in the repo market he engaged in repurchase agreement transactions (hereafter "repos") (which were sales of securities subject to agreement to repurchase them at a fixed price at a later date) and reverse repurchase agreements (hereafter "reverse repos") (which were purchases of securities subject to agreement to resell them at a fixed price at a later date).

36. In his repo market transactions for DSC, Heuwetter from time to time employed the services of finders. One such finder was Buttonwood Management Corp. ("Buttonwood"). At other times, Heuwetter transacted repos and/or reverse repos directly with other dealers.

37. Utilizing Buttonwood's services, on behalf of DSC, Heuwetter established a course of business in the repo market whereby dealers engaging in repo transactions would at various times deliver government securities to one of three banks and such securities would then be delivered to DSC (a reverse repo for DSC); to a significantly lesser extent DSC would deliver securities to one of such banks and such securities would then be delivered to another dealer (a repo or so-called financing transaction for DSC). More specifically:

(a) From in or about February 1981 to on or about February 1, 1982 DSC engaged in such transactions with or through United States Trust Company ("U.S. Trust");

(b) In or about January 1982, DSC engaged in such transactions with or through Manufacturers Hanover Trust Company ("Manufacturers Hanover");

(c) From in or about October 1980 to on or about February 1, 1982, DSC engaged in such transactions with or through Chase Manhattan Bank, N.A. ("Chase").

38. While engaged in the course of business described in paragraphs 34 through 37 above, Heuwetter, on behalf of DSC, continually sold in the outright or cash market securities representing the approximate amount by which the securities received in reverse repo transactions exceeded in amount the securities delivered in repo transactions. This course of business produced an effective short position, because once securities had been sold outright they would eventually have to be purchased outright in order to deliver at the termination of open reverse repo transactions. These positions involved the sale of what were, effectively, borrowed securities; the securities obtained in reverse repos had to be resold or returned to the dealer who originally sold them to DSC.

39. While engaged in the course of business described in the preceding paragraph, DSC created working capital for its government securities operations or for the general use of the firm. Such working capital was attributable to different government securities pricing methods then prevailing in the outright and repo markets. In the outright market, securities were priced to include accrued coupon interest, but in the repo market accrued interest was not paid at time of delivery, but only once it had been paid to the record owner on the stated coupon payment date, after which payment the owner was required immediately to remit the interest payment to the dealer having sold the securities in an open repo transaction.

Thus, DSC received money for securities sold outright which it did not have to pay to the contra parties in reverse repo transactions until a future date.

40. By the close of the last business day of January, 1982, DSC's net open short position in government securities was approximately $2 billion. The cost to cover this position net of collateral, rebates and accrued interest receivable was approximately $190 million.

41. DSC's short position in government securities, and the attendant deficit, described in the preceding paragraph, were improperly, falsely and misleadingly reflected on DSC's books as part of a so-called matched book of government securities borrowed and loaned (reverse repo/repo); specifically, the short position was so reflected as securities loaned (sold on repo) to a shell entity, called Fixed Income Government Securities, which was neither a bona fide government securities dealer nor an arms-length DSC customer, when such securities had, in fact, been sold outright to bona fide government securities dealers. The accrued coupon interest liabilities and net unrealized losses (cost to cover) on such short positions were not reflected on DSC's books.

42. Because of the condition described in the preceding two paragraphs, on or before the last business day of January, 1982, DSC was insolvent and could meet its government securities obligations as they came due only by continuing to open reverse repo positions and continuing to obtain working capital by outright sales of reversed-in securities carrying relatively mature interest coupons.

DGSI Established

43. On January 8, 1982, Ossorio retained Essner of Arthur Andersen to assist DSC in establishing DGSI, so that DGSI would be unregulated by the New York Stock Exchange and assume DSC's government securities position by February 1, 1982. Essner assembled a team of one tax partner and two

audit employees for consultation purposes. Based on figures supplied by Ruppert, the team developed alternative plans for the so-called spin-off of DGSI. On or about January 29, 1982, Essner submitted, and Ossorio approved, a plan which established DGSI as a separate entity, whereby DSC would transfer to DGSI $5 million in assets including the government securities position, in exchange for $5 million of preferred stock in DGSI.

44. On January 31, 1982, at Ossorio's request, Essner drafted a letter dated February 1, 1982 for Heuwetter's signature. This letter, announcing the formation of DGSI and stating its purported capital, of $20.8 million, was distributed to Chemical Bank, DSC's, and DGSI's clearing bank, as well as to Salomon Brothers, and Donaldson Lufkin Jenrette Securities Corporation ("DLJ"), among other government securities dealers, as Essner knew it would be.

45. The aforementioned letter proved inadequate to establish DGSI's credit and on February 10, 1982, Ossorio so informed Essner and requested a more formal document from Arthur Andersen. Essner offered to audit and certify the DGSI Statement of Subordinated Debt and Equity. He requested and obtained legal confirmation of the issuance of common stock, a subscription for common stock, issuance of subordinated debt and the executory transfer of assets from DSC to DGSI. The consultation team was not reconvened nor informed that an audit had been undertaken.

46. While conducting the purported audit described in paragraph 44, Essner violated Generally Accepted Auditing Standards by, among other things, failing to:

(a) examine records of or attempt to value or test the valuation of transferred assets, including DSC's government security positions;

(b) obtain or seek information regarding events between February 1 and February 22, when the report was issued;

(c) investigate the related party nature of the transaction or insist upon its full disclosure.

47. Thus, on February 22, 1982, Essner issued the Essner Report, dated February 1, 1982 and containing a full unqualified opinion. Essner's issuance of said report violated internal Arthur Andersen procedures in that, among other things, Essner failed to complete a questionnaire pertaining to his audit steps, failed to obtain the review of a second partner and failed to have a person outside the audit team check the final report against the work papers.

48. The Essner Report specifically and falsely represented that the assets, including the government securities position had been transferred from DSC to DGSI, and had been fairly valued, when in fact, Essner, Ossorio, Ruppert and Heuwetter knew Essner had neither valued the assets nor tested their valuation and that the transfer agreement remained executory.

49. The Essner Report failed to disclose that the $15.8 million in subordinated debt and common stock, issued to Heuwetter by DGSI, had been issued for cash which DSC paid, directly or indirectly, to Heuwetter and that all or part of said sum was in effect an unsecured loan by DSC funded by its own borrowings and repaid in the amount of approximately $12 million on or about February 1, after DGSI opened for business.

50. Defendants DSC, Ossorio, Heuwetter and Ruppert sent the Essner Report to several banks and government securities dealers including Chase, Manufacturers Hanover, U.S. Trust, Chemical Bank, First Interstate Bank of California, Salomon Brothers and DLJ, as Essner knew it would be.

51. In establishing DGSI, defendants DSC, Ossorio, Heuwetter and Ruppert knew, should have known or recklessly disregarded the fact that DGSI would be and, in fact, was insolvent as DSC had been on the last business day of January 1982, as alleged in paragraph 42, above, and that DGSI could meet its obligations only by continuing to open new reverse

repo positions and by selling government securities in the outright market to raise additional working capital.

DGSI Transacts Business

52. On or about February 1, 1982, DGSI assumed the government securities business theretofore conducted by DSC. Such business was conducted by Heuwetter. DGSI assumed the repo and reverse repo positions of DSC, which positions carried with them the approximate $2 billion short position and $190 million deficit alleged in paragraph 40 above. Although in deficit, such positions, together with certain assets unrelated to DSC's government securities business, had purportedly been exchanged for $5 million in DGSI preferred stock, as falsely reflected by the Essner Report.

53. While engaging in government securities transactions on behalf of DGSI, Heuwetter, between about February 1 and May 17, 1982:

(a) engaged in outright or cash transactions amounting to over $100 million per day;

(b) continued to engage in repo and reverse repo transactions so that open reverse repo transactions generally exceeded open repo transactions by from $1 billion to $2 billion;

(c) continued the practice, aileged in paragraphs 37, 38 and 39 above, of selling short government securities with relatively mature coupons, held under open reverse repos, in order to raise working capital.

54. While engaged in the transactions described in the preceding paragraph, Heuwetter, on behalf of DGSI, continued to engage in repo and reverse repo transactions with or through Manufacturers Hanover, U.S. Trust and Chase, and with various government securities dealers, including DLJ.

DGSI Collapses

55. During the period from about February 1 to May 14, 1982, DGSI, as Heuwetter knew, experienced various financial difficulties, including but not limited to the following:

(a) During February, March and April, its government bond clearing account at Chemical Bank was frequently overdrawn in excess of approved credit lines; funds continually had to be transferred at Ruppert's direction between DSC's and DGSI's accounts at such bank; by April 28 bank officials had terminated all payments made in anticipation of receipts and informed Heuwetter and Ossorio that either DGSI or DSC would have to obtain other banking facilities within 60 days;

(b) On or about March 2, 1982 U.S. Trust informed Heuwetter he could not maintain up to $2 billion in reverse repo positions in a matched book with that bank and U.S. Trust continued to reduce its position with DGSI;

(c) The reduction of positions with U.S. Trust forced Heuwetter to increase DGSI's positions with other banks and dealers;

(d) On or about March 10, 1982 an official of Manufacturers Hanover informed Heuwetter that DGSI would have to fund a special account to collateralize accrued coupon interest liability on DGSI's reverse repo positions, but between such date and May 14 Heuwetter underfunded such account;

(e) In late March, 1982, Morgan Stanley & Co., Inc., informed Heuwetter that it had rejected any further repo market transactions with DGSI;

(f) On or about April 13, 1982, officials of Chase informed Heuwetter they were troubled by DGSI's late delivery of securities which involved attendant interest claims by Chase against DGSI;

(g) On or about April 27, 1982 another repo market partner of DGSI, DLJ, informed Heuwetter that it was imposing trading limits on DGSI of $300 million total positions, including no more than $125 million in reverse repos, which represented a material and significant reduction in available reverse repo opportunity for DGSI;

(h) Between April 30 and about May 7, 1982, DGSI delayed paying Chase approximately $16 million in partial accrued coupon interest payments; having failed to make payment in the normal manner through the Federal Reserve Bank of New York, DGSI issued checks to Chase, stopped payment on the checks and ultimately paid Chase with securities;

(i) On or about May 10, DLJ informed Heuwetter that DGSI's repo and reverse repo positions with that firm would have to exactly balance in accrued coupon interest liability;

(j) Also, on or about May 10, 1982, officials of Chase informed Heuwetter that DGSI's positions with or through that bank would have to undergo a gradual, but total reduction or wind-down.

56. In each instance of financial difficulty as alleged in the preceding paragraph, Heuwetter failed to disclose any of DGSI's problems set out above to any of the banks or dealers, not already directly aware of them, nor did he ever disclose the hidden short position and accompanying deficit which underlay such problems to any parties with whom DGSI engaged in securities transactions from February 1 to May 17, 1982.

57. On or before Friday, May 14, 1982, Heuwetter knew that DGSI would be unable to make accrued coupon interest payment for May 15, payable on Monday, May 17. Such payments were at least $180 million.

58. Despite the facts heretofore alleged and particularly despite his knowledge that DGSI would likely fail on May 17,

on May 14 Heuwetter continued active trading in the cash and repo markets. On that day Heuwetter, on behalf of DGSI, undertook outright purchase obligations with other dealers of at least $1,663 million and sales obligation of at least $658 million.

59. On Monday, May 17, 1982, DGSI defaulted on approximately $180 million in accrued coupon interest due Chase and Manufacturers Hanover or their customers.

60. Despite the default alleged in the preceding paragraph, Heuwetter, on May 17, continued to engage in transactions for DGSI in the outright market, which transactions failed to settle on May 18.

61. On or about May 19, Heuwetter, on behalf of DGSI, concluded an agreement with Chase Manhattan Bank for the bank to assume the assets and liabilities of DGSI.

62. In the aftermath of DGSI's collapse, Chase reported total net losses of $285 million arising from DGSI's interest and trading obligations; Manufacturers Hanover reported such losses of $21.3 million.

First Cause of Action

Fraud in the Offer and Sale, and in Connection With the Purchase or Sale of Securities; Violation of Section 17(a) (1) of the Securities Act, 15 U.S.C. § 77q(a) (1), Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5, Thereunder

63. The Commission realleges and incorporates by reference each and every allegation in paragraphs 1 through 62, above.

64. Defendants DSC, Heuwetter, Ossorio, and Ruppert, from on or before January 1, 1982, and Essner, from on or about January 8, 1982, to on or about May 17, 1982, directly and indirectly, singly and in concert, and aiding and abetting each other, in the offer and sale and in connection with the purchase and sale of government securities, employed devices, schemes, and artifices to defraud, made untrue statements of

material facts or omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and engaged in acts, practices and courses of business which operated, or would operate as a fraud and deceit upon the purchasers and sellers or prospective purchasers and sellers of government securities, among others.

65. As part of and in furtherance of such conduct:

(a) Defendants DSC, Heuwetter, Ossorio and Ruppert from on or before January 1, 1982 to on or about January 31, 1982 conducted a government securities business at DSC while, as they knew, should have known or recklessly disregarded, DSC was insolvent and DSC had deficits relating to such business which it could not meet; nevertheless, such defendants falsely represented to persons invited to do and doing business with it that DSC was solvent and able to meet its obligations in a timely manner;

(b) Defendants DSC, Heuwetter, Ossorio and Ruppert from on or before January 1, 1982, to on or about February 28, 1982, and Essner from on or about January 8, 1982 to on or about February 28, 1982 caused DGSI to be established to transact business in government securities when such firm had been burdened with DSC's undisclosed and hidden government securities related deficit of approximately $190 million, a fact which they failed to disclose to persons invited to do and doing business with DGSI;

(c) Defendants DSC, Ossorio, Heuwetter, Ruppert and Essner, on or about February 24, 1982, issued or caused to be issued to prospective and actual customers of DGSI, with whom DGSI was engaging or sought to engage in transactions in government securities, the Essner Report which was never revoked, modified or withdrawn and which, among other things:

(1) materially and falsely represented that DGSI had $20.8 million in capital, when in fact, as defendants knew, had reason to know, or recklessly disregarded, DGSI had negligible capital and was instead burdened with an initial deficit or shortfall of approximately $190 million;

(2) materially and falsely stated that certain DSC operating assets and related liabilities, which in light of the circumstances reasonably referred in part to DSC's government securities positions, having a net fair value of $5 million, had been transferred to DGSI in exchange for preferred stock, when in fact, as defendant knew, had reason to know or recklessly disregarded, such assets and liabilities had not then been fully transferred and that Essner had neither valued, nor tested the valuation of, such assets and liabilities;

(3) materially failed to disclose what defendants knew, should have known or recklessly disregarded, to wit: that $15.8 million of DGSI's purported capital had been furnished by Heuwetter, who had received such funds directly or indirectly from DSC and that at least $12 million of such funds were returned to DSC on DGSI's first day of business and used to repay DSC's indebtness.

(d) Defendant Heuwetter, from on or about February 1, 1982 to on or about May 17, 1982, caused DGSI to engage in the business of trading government securities in both the outright or cash and repo markets while, as he knew, should have known or recklessly disregarded, DGSI was insolvent, as alleged in sub-paragraph (b), above, but while he, nevertheless, in addition to the misrepresentations and failures to disclose alleged in sub-paragraph (c), falsely represented to persons invited to and doing business with it

that DGSI was solvent and able to meet its obligations in a timely manner.

66. In the alternative and in addition to the foregoing, DSC, Heuwetter, Ossorio and Ruppert violated the anti-fraud provisions by establishing and causing the establishment of DGSI through or by means of which to carry on the government securities business of DSC, when, because of the condition of such business, as alleged above, its continuation by such defendants at DSC would have violated the anti-fraud provisions and, as continued by DGSI did, as alleged above, violate such provisions.

67. By reason of the foregoing acts, practices and course of conduct, defendants DSC, Heuwetter, Ossorio, Ruppert and Essner have violated, or aided and abetted violations, of Section 17(a) (1) of the Securities Act, 15 U.S.C. § 77q(a) (1), and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j (b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder, and unless enjoined will again commit or aid and abet such violations.

SECOND CAUSE OF ACTION

Fraud in the Offer and Sale of Securities; Violations of Sections 17(a) (2) and (3) of the Securities Act, 15 U.S.C. § 77q(a) (2), (3)

68. The Commission realleges and incorporates by reference each and every allegation in paragraphs 1 through 67 above.

69. Defendants DSC, Heuwetter, Ossorio and Ruppert, from on or before January 1, 1982, and Essner, from on or about January 8, 1982, to on or about May 17, 1982, directly and indirectly, singly and in concert, and aiding and abetting each other, in the offer and sale of government securities, obtained money or property by means of untrue statements of material facts or omissions to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, and engaged in transactions, practices, and courses of business

which operated or would operate as a fraud and deceit upon the purchases of such securities.

70. As part of and in furtherance of such conduct, defendants engaged in the courses of conduct specifically alleged in paragraphs 65 and 66 above.

71. By reason of the foregoing acts, practices and course of conduct, defendants have violated, or aided and abetted violations of, Section 17(a) (2) and (3) of the Securities Act, 15 U.S.C. § 77q (a) (2), (3), and unless enjoined will again commit or aid and abet such violations.

THIRD CAUSE OF ACTION

False and Incomplete Books and Records; Violation of Section 17(a) (1) of the Exchange Act, 15 U.S.C. 78q(a) (1) and Rules 17a-3 (a) (2), (a) (4) (C) and (a) (5), 17 C.F.R. §§ 240.17a-3(a) (2), (a) (4) (C) and (a) (5) Promulgated Thereunder

72. The Commission realleges and incorporates by reference each and every allegation in paragraphs 1 through 71 herein.

73. From in or before January, 1982 to February, 1982 defendant DSC, aided and abetted by defendants Heuwetter, Ossorio and Ruppert violated Section 17(a) (1) of the Exchange Act, 15 U.S.C. § 78q(a) (1) and Rule 17a-3(a) (2), 17 C.F.R. § 240.17a-3(a) (2), thereunder, in that DSC failed to keep accurate and current ledgers or other records reflecting all assets and liabilities of the government securities area of DSC. DSC's books and records recorded its government securities assets as approximately $3 million net of liabilities when in fact DSC had a deficit in such area of approximately $190 million.

74. From in or before January, 1982 to February, 1982, defendant DSC, aided and abetted by defendants Heuwetter, Ossorio and Ruppert violated Section 17(a) (1) of the Exchange Act, 15 U.S.C. § 78q(a) (1) and Rule 17a-3(a) (4) (C), 17 C.F.R. § 240.17a-3(a) (4) (C), thereunder, in that DSC failed to keep accurate and current ledgers or other records reflecting securities borrowed and securities loaned; the records repre-

sented that DSC had loaned ("repo'd out") approximately $3.7 billion in government securities when in fact it had sold these securities short. Moreover, approximately $1.7 billion of the government securities DSC reflected as borrowed ("reversed-in"), it had in fact purchased outright.

75. From in or before January, 1982 to February, 1982 defendant DSC aided and abetted by defendants Heuwetter, Ossorio and Ruppert violated Section 17(a) (1) of the Exchange Act, 15 U.S.C. § 78q(a) (1) and Rule 17a-3(a) (5), 17 C.F.R. § 240.17a-3(a)(5), thereunder, in that DSC failed to make and keep accurate and current ledgers or other records reflecting all short and all long positions, because no record represented the approximately $3.7 billion short position, or $1.7 billion long position in government securities referred to in the preceding paragraph.

76. By reason of the foregoing acts, practices and courses of conduct, defendant DSC has violated, and defendants Heuwetter, Ossorio and Ruppert have aided and abetted violations of, Section 17(a) (1) of the Exchange Act and Rules 17a-3(a) (2), 17a-3(a) (4) (C) and 17a-3(a) (5), thereunder, and unless enjoined will again violate or aid and abet such violations.

WHEREFORE, Plaintiff Commission respectfully demands that this Court issue:

A. A Final Judgment of Permanent Injunction enjoining defendant DSC, its officers, directors, agents, employees, servants, nominees, successors and assigns and defendants Ossorio, Heuwetter, Ruppert and Essner, their agents, employees, servants, nominees, successors and assigns, and all persons in active concert or participation with them, directly and indirectly, singly or in concert, or aiding and abetting each other, in the offer or sale, and in connection with the purchase or sale, of any security, by the use of any means or instruments of transportation or communication in, and the means or instrumentalities of, interstate commerce, or of the mails, from:

(a) employing any device, scheme or artifice to defraud;

(b) obtaining any money or property by means of, or otherwise making, any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(c) engaging in any act, transaction, practice or course of business which operates or would operate as a fraud or deceit upon any person;

in violation of Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5.

B. A Final Judgment of Permanent Injunction enjoining defendants DSC, Ossorio, Heuwetter and Ruppert, and such other persons and entities set out at paragraph A immediately above, directly and indirectly, singly or in concert, from violating, or aiding and abetting violations of:

Section 17(a) (1) of the Exchange Act, 15 U.S.C. § 78q(a) (1) and Rules 17a-3(a) (2), 17a-3(a) (4) (C) and 17a-3(a) (5) thereunder, by failing to make, maintain or keep accurate and complete such ledgers or other records required under such Rules, relating to assets and liabilities, income and expense and capital accounts, securities loaned and borrowed and long and short positions.

C. An Order that defendants Ossorio and Heuwetter, prior to opening any account with any broker or dealer for the purpose of conducting transactions in securities shall each deliver to such broker or dealer, or persons associated or employed therewith, true and complete copies of the Final Judgment of Permanent Injunction pertaining to each of them which may be granted by this Court, and any opinion issued in connection therewith.

D. Such other and further relief as this Court deems appropriate under the circumstances.

Respectfully submitted,

/s/ DONALD N. MALAWSKY

Donald N. Malawsky
Regional Administrator

Attorney for Plaintiff
SECURITIES AND EXCHANGE COMMISSION
New York Regional Office
26 Federal Plaza
New York, New York 10278
Telephone No.: (212) 264-1603

Dated: New York, New York
July 27, 1983

OF COUNSEL:
Jason R. Gettinger
LaBrena J. Martin
Loretta Kirsch Prives

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

83 Civ. 5599 (RWS)

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

—against—

DRYSDALE SECURITIES CORPORATION, DAVID J. HEUWETTER, JOSEPH V. OSSORIO, DENNIS J. RUPPERT, WARREN ESSNER,

Defendants.

PLAINTIFF'S ANSWERS TO DEFENDANT ESSNER'S FIRST SET OF INTERROGATORIES TO PLAINTIFF

INTRODUCTION

Plaintiff Securities and Exchange Commission ("Plaintiff") hereby submits its Answers to Defendant Warren Essner's First Set of Interrogatories made pursuant to Rule 33 of the Federal Rules of Civil Procedure.

The Answers are made without waiver of, and with preservation of:

(a) All questions as to competency, relevancy, materiality, privilege, admissibility of the response, and the subject matter thereof as evidence for any purpose in this action (including the trial of this action), and in any other action;

(b) The right to object to the use of any such response or the subject matter thereof, on any ground, in any

further proceedings in this action (including the trial of this action), and in any other action;

(c) The right to object on any ground at any time to a demand or request for the further response including further production of documents or any other discovery proceedings involving or relating to the subject matter of the interrogatories herein responded to; and

(d) The right at any time to amend, correct, add to, strike, delete, supplement or clarify any of the responses contained herein.

The following responses (and any further response to defendant's interrogatories) are made expressly without acknowledgement of materiality or relevance of the interrogatories or that the interrogatories are in any way reasonably calculated to lead to the discovery of admissible evidence.

Except where otherwise noted, plaintiff has endeavored to include in its answers all major evidentiary facts which respond to defendant's interrogatories and which are in plaintiff's physical possession as of the date of the answers. However, due to inadvertence or oversight plaintiff may have omitted certain facts in responding to a question which may be introduced at trial. Consequently, no representation is being made that every item of evidence to be introduced by plaintiff at trial relating to the subject matter of an interrogatory has been included in the answer thereto. Moreover, plaintiff makes no representation as to whether the information provided in its answers will in fact be introduced by plaintiff at trial.

GENERAL PRIVILEGE

Plaintiff declines to identify communications or documents, or to set forth information, which are covered by the governmental, attorney-client or work product privileges. These communications and documents are as follows:

1. Notes and memoranda prepared by the Commission's staff;

2. Legal and technical research by the Commission's staff;

3. Digests, indices and summaries of testimony;

4. Documents reflecting communications with law enforcement, licensing or self-regulatory authorities pertaining to enforcement or disciplinary action with respect to any individual or entity;

5. Documents reflecting communications with parties or their counsel relating to settlement of the subject action;

6. Written submissions to the Commission by any individual or entity relating to their liability under the securities laws, based on the facts underlying the subject action;

7. Documents reflecting communications among the Commission's staff and/or with members of the Commission; and

8. Documents prepared by the Commission's staff in preparation of this and any other actions or proceedings based on the underlying facts of this Complaint.

Plaintiff declines to produce or describe categories of documents set forth in this General Privilege.

INTERROGATORY No. 1

Identify any and all persons interviewed or questioned in the course of the investigation of DSC and DGSI.

Answer

Plaintiff has informed Defendant's counsel that all transcripts of investigative testimony are available and have been or will be produced for review or reproduced at Defendant's expense. Such transcripts contain identifying information to the extent known to Plaintiff; accordingly, Plaintiff will in this Answer list the witnesses in its investigation and state their institutional affiliation, or past affiliation, as the case may be.

A. Former Officers or employees of BMC Acquisition Corp. D/B/A Buttonwood Management

Andrew Rutherford
Donald Remlinger
John Russo
Lucy Dente
Gus DiBiasi
Fred Trombino
Robert Ihle
Larry DeMonte
Gail Walsh
Guy Cutoli
Peter Caruso
Anthony Zero

B. Officers or employees of Donaldson Lufkin and Jenrette Securities Corp.

Frank Wilkerson (no transcript)
Richard MacWilliams
Michael Domenico
John De Long
Howard Singer
Thomas Anguilla

C. Officers or employees of Drexel Burnham Lambert Government Securities Inc.

John Stepffens (no transcript)
Michael Szezerbienski

D. Former officers or emloyees of Di ysdale Government Securities, Inc.

David Heuwetter
Garrett J. Schmeelk
Richard R. Guidal
Mary Hille
Kathleen Hession
Corrine A. Aversano
Edward E. Davis
Brian Sommerville

James W. Harris
Julie Stack (worked for Heuwetter and paid by another entity)
James Neese
John Bork (also a former FICAL employee)
Michael Pineles
James Ouelette
Richard Taaffe
William Hogan

E. Former or present officers or employees of Drysdale Securities Corp.

Eileen Farrington
Dennis Ruppert
John McEvoy
David Pass
Frank Lentz
Debra Barrone
Nancy Tweten
Peter Wasserman
Bruce Brewster
Paul Heuwetter
Richard Breck
Richard Burns
Joseph Ossorio (in addition to his testimony, during which he asserted the privilege against self incrimination, he was interviewed, but no contemporaneous notes were preserved after the interview concluded)
Grace Meccariello
Keith Spiegelman
John Siggins

F. Officers or employees of First Interstate Bank of California ("FICAL")

Alfred Blaylock (no transcript)
Gerard Conijn
Steve Mawhorter

Charles Sherban
Elmer Jesse

G. Officers or employees of Goldman Sachs and Co.
Macy D. Foley
Jacob Schuster

H. Officer or employees of Harris Trust Savings Bank (Chicago,Ill.)
Nancy Wolcott
Suzanne Bellmore
Phillip Smith
John Butler (former employee)

I. Employee of J. Henry Schroder Bank and Trust Co.
Jeffrey Casprini

J. Employee of Mellon Bank International
Linda Dinardo

K. Officers or employees of Merrill Lynch Government Securities, Inc.
Gerard Reilly
Michael Frieband
John Perini
Howard Shallcross
Frank Eelio (no transcript)

L. Employees of Paine, Webber, Jackson and Curtis
David Rosenberg
Marc Greenspan
Howard Miller (former employee)

M. Partners or employees of Arthur Andersen and Co.
Mr. Essner
Edward Cohen
Mark Ramler
Joseph Spillane (former employee)
Geoffrey Harfst (not interviewed or examined, but Plaintiff has and will provide an affidavit)

N. Officers or employees of Manufacturers Hanover Trust Comapny

George Martello (former officer)
Andrew D'Amore

O. Officers or employees of Chase Manhattan Bank

Robert Adams
William Aimetti (former officer)
John Barthel (former officer)
John Dudek (former officer)
Douglas Bouchard (former officer)
Joseph Scuderi (former officer)
Andrea McIntyre
William Burgoon
William Butcher
Peter Demmer (former officer)
Anson Elliot
Wayne Hansen (former officer)
Richard Higgerson (former officer)
William Hinchman (former officer)
Thomas LaBrecque
Harmet Monker
William Ogden (former officer)
Richard Toomey

P. Employee of First Boston Corp.

Kevin Walsh (no transcript)

Q. Employee of Morgan Stanley, Inc.

Thomas Melzer

R. Officers or employees of Salomon Brothers, Inc.

Craig Coates (no transcript)
William Koster (no transcript)

S. Officers of Chemical Bank

Nancy Hollander (former officer)
Stephen Laserson

T. Officers or employees of FSI Futures
Robin Rodriguez
Lisa Roth

Plaintiff states that in many instances witnesses asserted the privilege against self-incrimination and testified, if at all, to certain identifying information only. Where no transcript is available, there are only non-verbatim notes, which we deem to be attorney work product and privileged.

INTERROGATORY No. 2

With respect to the allegations contained in paragraph 2 of the complaint, identify the sources of plaintiff's information and the grounds for its belief as to the truth of the allegation that Essner is "about to engage" in acts, practices and courses of business violative of the anti-fraud provisions of the federal securities laws.

Answer

Plaintiff contends that the facts alleged in the Complaint, particularly those relating directly or indirectly to Essner, support the "about to engage" conclusion in paragraph two of the Complaint; plaintiff objects to giving any more specific answer on the grounds such would divulge counsel's privileged legal theories, analysis, mental impressions and opinions and other work product, contrary to Rule 26 of the Federal Rules of Civil Procedure.

INTERROGATORY No. 3

With respect to the allegations contained in paragraph 46 of the complaint, identify the provisions of the AICPA's Statements on Auditing Standards upon which plaintiff relies.

Answer

Plaintiff relies upon SAS numbers 1, 2, 5, 6, 12, 14, 19, 31, 32, in whole or in part.

INTERROGATORY No. 4

With respect to the allegations contained in paragraphs 63 through 67 of the complaint, state whether Essner is being named as a principal or as an aider and abettor.

Answer

Essner is being named as a principal and, in the alternative, as an aider and abettor, except with respect to paragraph 66, as an aider and abettor only.

INTERROGATORY No. 5

With respect to the allegations contained in paragraphs 68 through 71 of the complaint, state whether Essner is being named as a principal or as an aider and abettor.

Answer

Essner is being named as a principal and, in the alternative, as an aider and abettor, except with respect to allegations incorporated by paragraph 70, as an aider and abettor, only, as to the acts alleged in paragraph 66.

INTERROGATORY No. 6

With respect to the Interrogatories (4) and (5), immediately above, if Essner is being named as an aider and abettor in either instance, identify the persons who committed the primary violations.

Answer

Drysdale Securities Corporation, David J. Heuwetter, Joseph V. Ossorio and Dennis J. Ruppert committed the primary violations.

INTERROGATORY No. 7

State whether plaintiff contends that Essner had actual knowledge of falsity with regard to the following allegations contained in paragraph 65 of the complaint:

(a) that DSC had an undisclosed and hidden government securities related deficit of approximately $190 million;

(b) that DGSI had been burdened with DSC's undisclosed and hidden government securities related deficit;

(c) that the audit report materially and falsely represented that DGSI had $20.8 million in capital;

(d) that DGSI had negligible capital;

(e) that the audit report materially and falsely represented that certain DSC operating assets and related liabilities having a net fair value of $5 million had been transferred to DGSI in exchange for preferred shares;

(f) that the assets and liabilities referred to in subparagraph (e), immediately above, had not then been fully transferred;

(g) that the $15.8 million of DGSI's capital which had been furnished by Heuwetter had been received by Heuwetter directly or indirectly from DSC;

(h) that at least $12 million of the $15.8 million referred to in subparagraph (g), immediately above, was returned to DSC on DGSI's first day of business and used to repay DSC's indebtedness.

Answer

(a) no
(b) no
(c) yes
(d) no
(e) yes
(f) yes
(g) no
(h) no

INTERROGATORY No. 8

If plaintiff contends that Essner had actual knowledge of falsity of any allegation specified in Interrogatories 7(a)-7(h), identify for each such allegation the persons, documents and communications upon which plaintiff relies for its contention.

Answer

Principally, Plaintiff relies upon Essner's own testimony, the Arthur Andersen and Co. work papers and the other documents identified at Essner's testimony, including the Essner report.

INTERROGATORY No. 9

State whether plaintiff contends that David Heuwetter had actual knowledge of falsity with regard to each of the allegations contained in paragraphs 65 and 66 of the complaint.

Answer

Yes.

INTERROGATORY No. 10

State whether plaintiff contends that Joseph Ossorio had actual knowledge of falsity with regard to each of the allegations contained in paragraphs 65 and 66 of the complaint.

Answer

Plaintiff has not alleged solely, nor does it now solely contend, that Defendant Joseph Ossorio had actual knowledge of falsity with regard to the allegations of paragraphs 65 and 66, except that Plaintiff does contend that Ossorio had actual knowledge of falsity at least with regard to the allegations of paragraph 65(c)(2).

INTERROGATORY No. 11

State whether plaintiff contends that Dennis Ruppert had actual knowledge of falsity with regard to each of the allegations contained in paragraphs 65 and 66 of the complaint.

Answer

Yes.

INTERROGATORY No. 12

If plaintiff contends that David Heuwetter, Joseph Ossorio or Dennis Ruppert did not have actual knowledge of falsity

with regard to any allegation contained in paragraphs 65 and 66 of the complaint, identify for each such allegation the persons, documents and communications upon which plaintiff relies for its contention.

Answer

With regard to Mr. Ossorio's knowledge, actual or constructive, Plaintiff refers to the facts and circumstances alleged in the complaint and to the testimony of Peter Wasserman, David Pass, John Siggins, Keith Spiegelman, Richard Breck, Frank Lentz, Nancy Tweten, Richard Burns, Stephen Laserson concerning the degree of authority and control Ossorio exercised over Drysdale Securities Corp. Plaintiff objects to this interrogatory, to the extent that it may seek more specific information, because in so doing the interrogatory would seek production of plaintiff's privileged legal theories, analyses, mental impressions and opinions of counsel, and other work product, contrary to Rule 26 of the Federal Rules of Civil Procedure.

Respectfully submitted,

DONALD N. MALAWSKY
Regional Administrator

By: /s/ JASON R. GETTINGER

Jason R. Gettinger
Senior Trial Counsel

Attorney for Plaintiff
SECURITIES AND EXCHANGE COMMISSION
New York Regional Office
26 Federal Plaza
New York, New York 10278
Telephone No.: (212) 264-1603

Dated: September 22, 1983
New York, New York

Of Counsel:
Jason R. Gettinger
LaBrena J. Martin
Loretta Kirsch Prives

STATE OF NEW YORK
COUNTY OF NEW YORK, ss.:

JASON R. GETTINGER, being duly sworn, deposes and says:

1. I am employed as an attorney by the Securities and Exchange Commission in its New York Regional Office.

2. The foregoing Responses to Defendant Essner's First Interrogatories to Plaintiff were prepared by me. I know the contents thereof and believe the Responses to be true and accurate.

/s/ JASON R. GETTINGER
Jason R. Gettinger

Sworn to before me this
22nd day of September, 1983

/s/ VERA B. GASKIN
Notary Public

VERA B. GASKIN
Notary Public, State of New York
No. 31-525983
Qualified in New York County
Commission Expires March 30, 1994

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

83 Civil 5599 (RWS)

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff,

—against—

DRYSDALE SECURITIES CORPORATION, DAVID J. HEUWETTER, JOSEPH V. OSSORIO, DENNIS J. RUPPERT, WARREN ESSNER,
Defendants.

CERTIFICATE OF SERVICE

JASON R. GETTINGER certifies:

1. I am an attorney employed by Plaintiff Securities and Exchange Commission at its New York Regional Office, and am admitted to practice before this Court.

2. On September 22, 1983, I caused to be delivered by mail both Plaintiff's Answers to Defendant Essner's First Set of Interrogatories to Plaintiff and Plaintiff's Response to Defendant Essner's First Request to Plaintiff for Production of Documents by depositing them in a receptacle of the United States Mail in postpaid envelopes addressed to the following:

Peter Flemming, Esq.
Curtis, Mallet-Provost, Colt & Mosle
101 Park Avenue
New York, New York 10016
Attorney for defendant Warren Essner

Charles Stillman, Esq.
Stillman Friedman & Shaw
521 Fifth Avenue
New York, New York 10175
Attorney for defendant Joseph V. Ossorio

Marvin Gersten, Esq.
Gersten Savage & Kaplowitz
150 East 58th Street
New York, New York 10155
Attorney for defendant David J. Heuwetter

Gerald Walpin, Esq.
Rosenman Colin Freund Lewis & Cohen
575 Madison Avenue
New York, New York 10022
Attorney for defendant Drysdale Securities Corporation

Jeffrey C. Hoffman, Esq.
Hoffman Pollok & Gasthalter
477 Madison Avenue
New York, New York 10022
Attorney for defendant Dennis J. Ruppert

JASON R. GETTINGER

Dated: September 22, 1983
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No. 85-1744

In the Supreme Court of the United States

OCTOBER TERM, 1985

WARREN ESSNER, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether misrepresentations concerning the financial condition of an insolvent government securities dealer, made to investors to induce them to engage in securities transactions with the dealer in which the dealer's financial condition was an important element, were "in" or "in connection with" the offer, purchase or sale of securities for purposes of the antifraud provisions of the federal securities laws.

TABLE OF CONTENTS

Page

Opinions below 1

Jurisdiction 1

Statement 1

Argument 5

Conclusion 13

TABLE OF AUTHORITIES

Cases:

Affiliated Ute Citizens v. *United States*, 406 U.S. 128 ..... 6, 9

Angelastro v. *Prudential-Bache Securities, Inc.*, 764 F.2d 939, cert. denied, No. 85-421 (Oct. 21, 1985) 7

Arrington v. *Merrill Lynch, Pierce, Fenner & Smith Inc.*, 651 F.2d 615 7

Arthur Lipper Corp. v. *SEC*, 547 F.2d 171, cert. denied, 434 U.S. 1009 6

A.T. Brod & Co. v. *Perlow*, 375 F.2d 393 ..... 6, 8

Brown v. *Ivy*, 661 F.2d 62, cert. denied, 455 U.S. 990 11

Chemical Bank v. *Arthur Andersen & Co.*, 726 F.2d 930, cert. denied, 469 U.S. 884 ..... 9, 11, 12

Competitive Associates, Inc. v. *Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811 ..... 8, 11

Page

Cases—Continued:

Costello v. *Oppenheimer & Co.*, 711 F.2d 1361 7

Herman & MacLean v. *Huddleston*, 459 U.S. 375 6

Ketchum v. *Green*, 557 F.2d 1022, cert. denied, 434 U.S. 940 ..... 10, 11

Philip J. Liuzza, In re, 10 S.E.C. 882 7

Pross v. *Katz*, 784 F.2d 455 11

R.A. Holman & Co. v. *SEC*, 366 F.2d 446 7

Rubin v. *United States*, 449 U.S. 424 ..... 9, 10

Santa Fe Industries v. *Green*, 430 U.S. 462 10

SEC v. *Raymond Bliss, Inc.*, 4 S.E.C. Jud. Dec. 834 7

SEC v. *Resch-Cassin & Co.*, 362 F. Supp. 964 7

Smallwood v. *Pearl Brewing Co.*, 489 F.2d 579, cert. denied, 419 U.S. 873 10

Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6 ..... 6, 7, 8, 9, 10

United States v. *Naftalin*, 441 U.S. 768 ..... 6, 7, 8

United States v. *Newman*, 664 F.2d 12, cert. denied, 464 U.S. 863 10

Page

Cases—Continued:

United States v. *Peltz*, 433 F.2d 48, cert. denied, 401 U.S. 955 7

Wilson v. *First Houston Investment Corp.*, 566 F.2d 1235, vacated, 444 U.S. 959 11

Harold G. Wise, In re, 29 S.E.C. 542 7

Wisniewski v. *United States*, 353 U.S. 901 12

Statutes amd regulation:

Securities Act of 1933, § 17(a), 15 U.S.C. 77q(a) 4, 5, 6, 7, 9, 11

Securities Exchange Act of 1934, § 10(b) 15 U.S.C. 78j(b) 4, 5, 6, 7, 9, 11

17 C.F.R. 240.10b-5 ..... 4, 5, 7, 10

Miscellaneous:

N. Bowsher, *Repurchase Agreements*, in *Instruments of the Money Market* (T. Cook & B. Summers 5th ed. Fed. Reserve Bank of Richmond 1981) 2

H.R. Rep. 99-258, 99th Cong., 1st Sess. (1985) 9

Lucas, Jones & Thurston, *Federal Funds and Repurchase Agreements*, 2 Fed. Reserve Bank of N.Y. Q. Rev. 33 (1977) 2

Page

Miscellaneous—Continued:

Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess., *Report of the Joint Treasury-SEC-Federal Reserve Study of the Government-Related Securities Markets* (Comm. Print 1980) 2

T. Simpson, *The Market for Federal Funds and Repurchase Agreements* (Staff Study, Board of Governors of the Federal Reserve System 1979) 2

M. Stigum, *The Money Market: Myth, Reality, and Practice* (1978) 2

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A11) is reported at 785 F.2d 38. The opinion of the district court (Pet. App. A14-A22) is reported at 606 F. Supp. 295.

JURISDICTION

The judgment of the court of appeals was entered on February 21, 1986. The petition for a writ of certiorari was filed on April 21, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The fraud in this case involved repurchase transactions, known as "repo" and "reverse repo" transactions, in government securities by Drysdale Government Securities, Inc. (DGSI). A repo is the sale of a security to an investor with an agreement to repurchase the security from the

investor at a later date at a fixed price. A reverse repo is the purchase of a security from an investor with an agreement to resell the security to the investor at a later date at a fixed price.

The wholesale repo market in which these transactions occurred is an integral part of the market for United States government securities. Securities dealers, banks and other financial institutions, business corporations, and state and local governments participate in that market. The repo market enhances the liquidity of government securities and their attractiveness to investors, thereby facilitating the government's ability to finance the public debt. Government securities dealers use this market to acquire securities to cover short positions, make delivery of securities to customers, and finance their own securities portfolios. Structuring the transactions as purchases and sales of securities reduces delays and transaction costs and thus makes practical the transfer of funds on a short-term basis.[1]

Repo transactions involving United States government securities have been viewed by some market participants as carrying minimal risk. In fact, however, parties to these transactions are exposed to the risks of changes in the market value of the securities in response to interest rate fluctuations and of default by their counter-parties when the time comes to repurchase or resell the securities.[2]

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[1]See, *e.g.*, Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess., *Report of the Joint Treasury-SEC-Federal Reserve Study of the Government-Related Securities Markets* 28 (Comm. Print 1980); Lucas, Jones & Thurston, *Federal Funds and Repurchase Agreements*, 2 Fed. Reserve Bank of N.Y. Q. Rev. 33 (1977); T. Simpson, *The Market for Federal Funds and Repurchase Agreements* 39, 50, 65 (Staff Study, Board of Governors of the Federal Reserve System 1979); N. Bowsher, *Repurchase Agreements*, in *Instruments of the Money Market* 52, 55, 58 (T. Cook & B. Summers 5th ed. Fed. Reserve Bank of Richmond 1981).

[2]See, *e.g.*, M. Stigum, *The Money Market: Myth, Reality, and Practice* 314 (1978).

2. Petitioner was a partner in the accounting firm of Arthur Andersen & Co. The Securities and Exchange Commission's complaint alleged that petitioner assisted Drysdale Securities Corp. (DSC) in the spin-off of its government securities business through the formation of a new entity, DGSI. Petitioner authored a letter for distribution to securities dealers and banks announcing the formation of DGSI and stating its capital as $20.8 million. In fact, DGSI was insolvent, burdened with a deficit of $190 million arising out of the government securities positions that it assumed from DSC. Petitioner also executed an unqualified audit opinion with respect to a certified statement of DGSI's subordinated debt and equity. The opinion was based on a purported (but improperly conducted) audit. The statement repeated the representation that DGSI had capital of $20.8 million. The opinion and statement, like petitioner's earlier letter, were distributed to government securities dealers and banks with the purpose of inducing them to deal with DGSI. Pet. App. A3-A5, A16-A17, A34-A37, A41-A42.

Most of DGSI's business involved purchases and sales of government securities through repos and reverse repos. By taking advantage of then-existing disparities in prices, DGSI was able temporarily to generate funds to meet its inherited obligations by buying securities in reverse repos and selling them outright for a higher price in the cash market.[3] In order to redeliver the securities at the close of the reverse repo transactions, however, DGSI needed funds to purchase them again in the cash market. Thus, DGSI

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[3]In the repo market, the price paid by the purchaser did not take into account accrued coupon interest, while in the cash market it did. Thus, by purchasing securities in the repo market and selling them in the cash market, DGSI was able immediately to realize the accrued coupon interest. However, it was required to remit the interest as the coupons matured. Pet. App. A9 n.3, A15-A16, A33-A34.

could meet its commitments to investors and fund its large deficit only by continuously obtaining cash by buying government securities in reverse repo transactions and selling them in the cash market. Pet. App. A9 n.3, A15-A16, A34-A37.

When several of DGSI's reverse repo customers reduced their positions, this Ponzi-like scheme collapsed. DGSI defaulted on payments of over $180 million in accrued coupon interest (see note 3, *supra*) due Chase Manhattan Bank, Manufacturers Hanover Trust Co., and their customers, and it failed to settle transactions in the cash market. In the aftermath of DGSI's collapse, Chase and Manufacturers reported net losses from DGSI's failure to meet its interest and trading obligations of approximately $300 million. Pet. App. A14-A16, A38-A40.

3. a. The Commission brought this injunctive action against petitioner and others,[4] alleging that petitioner, with scienter, prepared and certified false financial statements that were used to induce investors to trade with DGSI, in violation of the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. The district court dismissed the complaint. Pet. App. A14-A22. The district court concluded that petitioner's misrepresentations were not made "in" the offer or sale of securities within the meaning of Section 17(a) or "in connection with" the purchase or sale of securities within the meaning of Section 10(b) because they "related to the capitalization of

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[4]The three other individual defendants, who were officers of DSC or DGSI, consented to the entry of permanent injunctions without admitting or denying the Commission's allegations. The action against DSC was voluntarily dismissed after the firm was dissolved. Pet. App. A3 & n.1.

DGSI, not to the value of the government securities underlying the 'repo' market or the financial stability of the issuer [*i.e.*, the United States]." Pet. App. A19.

b. The court of appeals reversed and remanded for further proceedings. Pet. App. A1-A11. The court of appeals held that there was a sufficient nexus between petitioner's fraud and the securities transactions, pointing out that "securities were transferred as a direct result" of the misrepresentations of DGSI's financial condition (*id.* at A11) and that these misrepresentations "directly involve[d]" the consideration for the securities transactions (*id.* at A7).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore unwarranted.[5]

Petitioner contends (Pet. 8-19) that fraudulently inducing investors to engage in securities transactions with an insolvent broker-dealer, where the dealer's financial condition is an important element of the transactions, is not actionable under the antifraud provisions of the federal securities laws. His primary argument is that Section 10(b) of the Securities Exchange Act, as implemented by Rule 10b-5, and Section 17(a) of the Securities Act, which require that the fraud be "in" or "in connection with" securities transactions, reach only those frauds that pertain to the

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[5]The interlocutory posture of this case is also a significant factor weighing against review at this juncture. The court of appeals reversed the district court's dismissal of the complaint and remanded for further proceedings. Petitioner will therefore be able subsequently to raise again through a petition for a writ of certiorari the issue he now asserts, together with any additional questions that may arise on remand, should a final judgment be entered against him. Moreover, the Court would not at this stage have the benefit of a factual record or findings from the district court.

value of the securities themselves. This argument is contrary to both the statutory language and five decades of uniform interpretation of that language by the Commission and the federal courts. Petitioner advances no sound reason in support of his contention that this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), should be overruled.

1. a. It is well established that the antifraud provisions apply to fraudulent transactions in securities whether or not the fraud relates to the value of the securities themselves. "Neither § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the 'investment value' of securities, and, indeed, it is established that a 10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value.' " *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 396-397 (2d Cir. 1967), cited in *Superintendent of Insurance*, 404 U.S. at 11 n.7.[6] Petitioner's position to the contrary would undercut longstanding and important protections for the victims of fraud perpetrated by broker-dealers. Rule 10b-5 has been construed to cover a variety of fraudulent activities involving the trading process or a course of dealing in securities apart from the value of the

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[6]Accord *Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171, 176 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978) ("the language of * * * Rule [10b-5] is broad enough to include * * * a course of dealing where the fraud concerns the overall relation of broker and customer rather than the overvaluation or undervaluation of a security sold or purchased"). See generally *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983) (Section 10(b) should be construed to effectuate its "broad proscription against fraud"); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972) ("These proscriptions, by statute and rule, are broad and, by repeated use of the word 'any', are obviously meant to be inclusive."). See also *United States* v. *Naftalin*, 441 U.S. 768, 773 n.4 (1979) (fraud that satisfies nexus requirement under Section 10(b) also comes within Section 17(a)).

securities, including such garden-variety securities frauds as churning, doing business while insolvent, and misrepresenting credit terms or trading risks.[7]

This Court confirmed this understanding of the antifraud provisions in *Superintendent of Insurance*. There, the Court upheld claims under Section 10(b) and Rule 10b-5 arising when a corporation selling United States Treasury bonds was "duped into believing that it * * * would receive the proceeds" of the sale. 404 U.S. at 9. Instead, the proceeds were misappropriated and used to purchase stock in the seller itself. The fraud did not relate to the value of the Treasury bonds. Nonetheless, the Court concluded that a federal cause of action was stated because the corporation "suffered an injury as a result of deceptive practices touching its sale of securities as an investor." *Id.* at 12-13.[8]

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[7]See, *e.g.*, *United States* v. *Naftalin*, *supra* (failure to disclose that securities were being sold short); *Angelastro* v. *Prudential-Bache Securities, Inc.*, 764 F.2d 939, 943-944 (3d Cir. 1985), cert. denied, No. 85-421 (Oct. 21, 1985) (nondisclosure of margin account credit terms); *Costello* v. *Oppenheimer & Co.*, 711 F.2d 1361, 1367-1368 (7th Cir. 1983) (churning); *Arrington* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615 (9th Cir. 1981) (misrepresentation of risks of margin trading); *United States* v. *Peltz*, 433 F.2d 48, 53 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971) (violation of margin and short sale price rules); *R.A. Holman & Co.* v. *SEC*, 366 F.2d 446, 451 (2d Cir. 1966) (confirmation to customers of unauthorized trades); *SEC* v. *Resch-Cassin & Co.*, 362 F. Supp. 964, 978 (S.D.N.Y. 1973) (doing business while insolvent); *SEC* v. *Raymond Bliss, Inc.*, 4 S.E.C. Jud. Dec. 834 (D. Mass. 1946) (same); *In re Harold G. Wise*, 29 S.E.C. 542, 544 (1949) (same); cf. *In re Philip J. Liuzza*, 10 SEC 882 (1941).

[8]Similarly, in *United States* v. *Naftalin*, 441 U.S. 768 (1979), the Court held that a broker-dealer violated the antifraud provisions of Section 17(a) by selling securities short through other broker-dealers that were unaware that the firm did not own the securities. Although the fraud did not pertain to the value of the securities, the Court quickly disposed of the contention that the fraud did not occur "in" their offer or sale. 441 U.S. at 773. While petitioner attempts (Pet. 18) to distinguish *Naftalin* on the ground that it related to the "existence" of the securities,

b. There is no doubt that the fraud alleged in this case satisfies the test of *Superintendent of Insurance,* as petitioner apparently admits (see Pet. 17). Indeed, although petitioner repeatedly implies that there was only an incidental relationship between the fraud and the transactions, in fact the fraud alleged here went to the heart of the securities transactions. Petitioner's false financial statements were prepared for presentation to persons who were thereby induced to enter into securities transactions in which DGSI's financial condition was a significant element. See pages 2-3, 5, *supra;* see also *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath,* 516 F.2d 811, 815 (2d Cir. 1975) (fraud was "directly related to the trading process"). The financial statements misrepresented a critical aspect of the consideration running to the investors in the transactions. See Pet. App. A7. An integral part of a repo or reverse repo is the dealer's agreement to repurchase the security from or resell it to the investor at a fixed price (and, in the reverse repos here, to pay matured coupon interest). As the court below observed, "DGSI's financial strength was essential to the value received by the other party in a securities transaction." *Id.* at A10. Induced to trade with DGSI by petitioner's misrepresentations, the investors did not get what they had bargained for in their securities transactions. Petitioner's fraud was therefore "in connection with" the repo and reverse repo securities

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in fact the frauds are indistinguishable. In *Naftalin,* as here, the misrepresentations went to the defendant's ability to deliver the securities he had sold, and the scheme collapsed when the firm was unable to fulfill its obligations to the other parties to the transactions. See 441 U.S. at 770-771. Likewise ill-founded is petitioner's attempt (Pet. 18) to distinguish *A.T. Brod & Co.* v. *Perlow, supra,* on the theory that not intending to pay for ordered securities is fraudulent under the federal securities laws while misrepresenting that a broker is financially able to pay for such securities is not.

transactions in a sense every bit as fundamental as if he had misrepresented the market value of the transferred bonds.[9]

2. Petitioner faults (Pet. 17) the court of appeals for faithfully applying this Court's decision in *Superintendent of Insurance* to the facts presented here. There is, however, no reason to doubt the continuing vitality or the correctness of that decision.

a. Petitioner's contention (Pet. 8, 12-13) that in *Rubin* v. *United States,* 449 U.S. 424 (1981), the Court called into question its holding in *Superintendent of Insurance* is without merit. The question in *Rubin,* which the Court answered in the affirmative, was whether a pledge of stock to a bank as collateral for a loan constituted an offer or sale of securities under Section 17(a). It was undisputed that the misrepresentation related to the value of the pledged stock, so the nexus issue was not raised. The comment on which petitioner relies (449 U.S. at 429 n.6) plainly was not meant to cast doubt on the Court's holding in *Superintendent of Insurance,* which was not mentioned in *Rubin.* Read in context, the comment was obviously intended to make it clear, as other courts subsequently articulated,[10] that *Rubin* did not extend the

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[9]Indeed, the very report cited by petitioner (Pet. 19 n.10) for the proposition that additional legislation would be required to give the Commission jurisdiction over the conduct at issue here recognizes that such conduct is already covered by Sections 10(b) and 17(a):

> Fraud in connection with repurchase or reverse repurchase transactions, including misrepresentations concerning the financial condition of the brokerage firm effecting the transactions, is covered by the antifraud provisions of the federal securities laws. * * * [T]he district court's decision to the contrary in *SEC* v. *Drysdale Securities Corp.* * * * is incorrect.

H.R. Rep. 99-258, 99th Cong., 1st Sess. 17 n.22 (1985).

[10]See *Angelastro* v. *Prudential-Bache Securities, Inc.,* 764 F.2d at 946; *Chemical Bank* v. *Arthur Andersen & Co.,* 726 F.2d 930, 944 (2d Cir.), cert. denied, 469 U.S. 884 (1984).

federal antifraud provisions automatically to every fraud that might occur in the course of conventional bank loans that happen to be secured by pledged stock. Petitioner cites no decision in which *Rubin,* which was decided in favor of federal antifraud coverage, has been interpreted to overrule or otherwise undermine the continuing authority of *Superintendent of Insurance.*

b. Petitioner's argument (Pet. 8-11) that the Court in *Superintendent of Insurance* enunciated a meaningless standard that has created conflict among the courts of appeals is just wrong. The Court's decision in that case has been interpreted by the lower courts to distinguish "deceptive devices and contrivances in the purchase or sale of securities" (404 U.S. at 12), which are covered by the antifraud provisions, from "transactions which constitute no more than internal corporate mismanagement" (*ibid.*), which are not. See, *e.g., United States* v. *Newman,* 664 F.2d 12, 17 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983); *Ketchum* v. *Green,* 557 F.2d 1022, 1027 (3d Cir.), cert. denied, 434 U.S. 940 (1977). Especially in light of *Santa Fe Industries* v. *Green,* 430 U.S. 462 (1977), which laid to rest any possible misconception concerning whether mere breaches of fiduciary duty are within Rule 10b-5, petitioner's characterization (Pet. 8) of federal jurisdiction over frauds as "essentially limitless" is erroneous. Rather, as petitioner elsewhere recognizes (Pet. 10), the lower courts have undertaken a case-by-case inquiry into whether a federal securities claim has been stated on the particular facts before them.

The "cautious case-by-case approach" (*Smallwood* v. *Pearl Brewing Co.,* 489 F.2d 579, 595 (5th Cir.), cert. denied, 419 U.S. 873 (1974)) adopted by the lower courts has not resulted in any conflict among the circuits. Although the precise articulation of the requirement has varied, the courts of appeals have looked for a demonstrable connection

between particular securities transactions, or a course of dealings in securities, and the alleged fraud. These courts have uniformly recognized that a fraud does not come within Section 10(b) or 17(a) simply because the particular transaction "happen[ed] to involve securities" (Pet. 18).[11] The cases cited by petitioner (Pet. 10-11) do not support his claim of a conflict.[12] Petitioner cites no case holding that the

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[11]See, *e.g.*, *Pross* v. *Katz*, 784 F.2d 455, 458-459 (2d Cir. 1986) (nexus requirement not satisfied where the fraud had "far too tenuous a connection with the securities transactions of years before"); *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d at 944 n.24 (nexus requirement not satisfied where the securities sale was "merely an incident in a transaction not otherwise involving the purchase or sale of securities"); *Ketchum* v. *Green*, 557 F.2d at 1027-1028 (nexus requirement not satisfied where purported deceptive practices occurred in connection with struggle for corporate control that occasioned forced sale of stock).

[12]Many of these cases were decided by lower courts within the Second Circuit, which of course are bound by the decision here. In any event, none of the cases on which petitioner relies conflicts with the decision here because the alleged misrepresentations in the cases finding no liability were remote from any decision to buy or sell securities, whereas here the alleged fraud directly induced investors to enter into securities transactions with DGSI. See, *e.g.*, *Ketchum* v. *Green*, 557 F.2d at 1028 (fraud was not "undertaken with the objective of inducing" the sale of stock and there were "a substantial number of intermediate steps between the fraud and the [sale]"). Nor is petitioner correct that the lower courts are in disarray. The cases he cites in support of this contention are all readily distinguishable on their facts. See, *e.g.*, *Brown* v. *Ivie*, 661 F.2d 62, 65 (5th Cir. 1981), cert. denied, 455 U.S. 990 (1982) (expressly distinguishing *Ketchum* v. *Green* on the ground that there was "a more direct causal connection between the fraud and the sale of securities than was present in *Ketchum*"); compare *Wilson* v. *First Houston Investment Corp.*, 566 F.2d 1235, 1243 (5th Cir. 1978), vacated on other grounds, 444 U.S. 959 (1979) (fraud too remote where plaintiff transferred control over stock portfolio to investment adviser on basis of misrepresentations concerning adviser's use of computer market analysis), with *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d at 815 (auditor violated Rule 10b-5 by accepting payoffs to provide false certified financial statements for purpose of inducing purchase of securities).

antifraud provisions are not violated where a person is fraudulently induced to purchase or sell securities through misrepresentations concerning the consideration that he would receive.

3. Finally, petitioner contends (Pet. 8, 15-16) that the decision below conflicts with *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984). To begin with, petitioner never presented this claim of an intra-circuit conflict to the Second Circuit through a suggestion of rehearing en banc, and any such conflict would of course be for that court to resolve. *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957). More important, *Chemical Bank* held only that fraud relating to the net worth of the borrower of a conventional bank loan is not covered by the antifraud provisions merely because the borrower also pledges a security. Unlike bank loans, the repos and reverse repos here were effected by a securities dealer in a securities market. DGSI entered into the reverse repo transactions for the very purpose of obtaining the securities for use in its business. It took title to those securities and was permitted to sell them, and in fact did sell them, in the market. By contrast, a bank does not lend money in order to obtain the security pledged as collateral, nor may it trade the security. In *Chemical Bank*, Judge Friendly expressly distinguished the case before the court from the situation where "sellers of securities are * * * tricked into parting with something * * * for a consideration known to the buyer not to be what it purports to be." 726 F.2d at 943. That, of course, is precisely this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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9pp

TABLE OF CONTENTS

	PAGE
Table of Authorities	ii
Preliminary Statement	1
Reply Argument	2
Conclusion	6

TABLE OF AUTHORITIES

Cases PAGE

Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984) 2, 3, 4

Rubin v. United States, 449 U.S. 424 (1981).....*passim*

Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).....2, 3, 5

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REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PRELIMINARY STATEMENT

Petitioner Warren Essner respectfully submits this Reply Brief in support of his Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit filed April 21, 1986, and in reply to the Brief in Opposition of the Securities and Exchange Commission (the "Commission") filed May 1986.[1]

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1 References to the Petition are cited "(Pet. at ____)." References to the appendix to the Petition are cited "(A ____)." References to the Commission's Brief in Opposition are cited "(Opp. at ____)."

REPLY ARGUMENT

This petition raises a single question of federal jurisdiction under the antifraud provisions of the federal securities laws: —Does federal jurisdiction exist when there is (a) an alleged misrepresentation, and (b) a securities transaction, regardless of whether the misrepresentation relates to the intrinsic value of the securities or "pertains" to the securities themselves in any other material way.

In our Petition we said resolution of this issue required a final determination of the conflict which exists between Justice Douglas' wide-reaching opinion in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), and both this Court's footnote to its opinion in *Rubin v. United States*, 449 U.S. 424, 429 n.6 (1981), and the opinion of Judge Friendly in *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984). We said (Pet. at 18):

> If, as in *Superintendent*, federal jurisdiction exists given (a) a fraudulent scheme which (b) happens to involve securities, then this Court should say so. If, however, federal jurisdiction exists only where the alleged fraudulent misrepresentations relate to the intrinsic value of the securities, or at the very least, pertain in a direct, material, and easily identifiable way to those securities themselves, this Court should say so. The inconsistency and chaos which has characterized this important area of federal law since 1971 must be eliminated. A clear definition of federal jurisdiction in matters involving securities must be established.

The Commission purports to resolve the issue without this Court's assistance by simply denying a conflict exists. It argues that *Superintendent* remains the controlling law, that *Rubin's* implicit limitation of *Superintendent* should be ignored as

irrelevant, and that Judge Friendly's decision in *Chemical Bank* is inapposite. The Commission's blithe treatment of a question which impacts *its* jurisdiction only underscores the need for certiorari in this case.

Rubin involved misrepresentations both of the value of securities pledged to secure a bank loan and of the financial condition of the borrower. This Court held a pledge of worthless stock violated the federal securities laws, but specifically refused to decide whether the borrower's false statement of financial condition—which actually induced the underlying loan transaction—was itself sufficient to establish federal jurisdiction. In a quite precise footnote this Court said:

> The misrepresentations at issue in this case related to the stocks themselves; petitioner does not allege that his conviction, insofar as it involved securities fraud under § 17(a), was based on misrepresentations made about the financial condition of Tri-State itself. Thus, we need not decide whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a).

449 U.S. at 429 n.6.

The Commission says this footnote "plainly was not meant to cast doubt on the Court's holding in *Superintendent of Insurance*" (Opp. at 9). But, if this is so, and if the footnote in *Rubin* "was not meant to cast doubt" on the reach of *Superintendent*, then, as even the Commission must concede, the *Rubin* footnote has no meaning at all. If that *is* the case, which seems most improbable, it is for this Court, and not for the Commission, to say so.

The Commission, undoubtedly insecure with a position which would leave the *Rubin* footnote without meaning, goes on to presume the *Rubin* footnote was only "intended to make it clear" that federal jurisdiction does not "extend . . . to every fraud which might occur in the course of conventional

bank loans" (Opp. at 9-10). Clearly, if that is what this Court meant in *Rubin*, it would have said so. But, the language of the footnote is not limited to "conventional bank loans," pledge transactions, or any other particular type of transaction which happens to involve securities. With obvious care, the footnote quite clearly leaves undecided the question of "whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves" can form the basis for federal jurisdiction under the federal securities laws.

Chemical Bank also involved a bank loan secured by common stock. But, unlike *Rubin*, no misrepresentations were made with regard to the value of the collateral and plaintiff's theory of liability was based entirely upon an allegedly false statement of the guarantor's financial condition. *Chemical Bank* therefore presented a fact pattern which required judicial determination of the very issue left undecided in the *Rubin* footnote. Judge Friendly concluded that while the financial statement may have induced a securities transaction, namely, a bank loan collateralized by common stock, the alleged misrepresentations did not pertain to the pledged stock, 726 F.2d at 943 n.22, and therefore were not actionable under the federal securities laws.

Petitioner's case is before the Court on the same basic set of facts as *Rubin* and *Chemical Bank*. Petitioner is charged with issuing a false statement of financial condition which induced secured loan transactions; however, it is conceded that DGSI's financial condition had no bearing on the genuine U.S. government bonds which were the subject of those transactions. In order to avoid Judge Friendly's holding in *Chemical Bank*, the Second Circuit was forced to distinguish DGSI's repurchase agreements from traditional secured loan transactions (A7-A8), and then held that the alleged misrepresentation of financial condition in this case was sufficient to establish federal jurisdiction because it purportedly affected the *consid-*

eration for DGSI's repurchase agreements (A10).[2] It therefore never answered the question raised in *Rubin*, namely, whether the alleged misrepresentation "pertained to" the *securities themselves*. The decision below therefore said nothing more than federal jurisdiction exists whenever there is a misrepresentation in a transaction which happens to involve securities. In short, the Court below applied *Superintendent* without regard to *Rubin*.

We end where we started. If, as indicated in *Superintendent*, the misrepresentation in a transaction which involves securities is sufficient to invoke federal jurisdiction, as the Commission contends and the court below held, then this Court should say so. However, if, as indicated in *Rubin*, the misrepresentation must relate to the value of the securities involved in the transaction, or otherwise pertain in a direct, material, and easily identifiable way to the securities themselves, as Judge Friendly held, then this Court should say so. We believe this important question of federal jurisdiction should be answered by this Court and not by the Commission.

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2 Quite clearly, the alleged misrepresentation of the guarantor's financial conditon in *Chemical Bank* affected the consideration for the secured loan transaction in that case. *See* 726 F.2d at 945 (Van Graafeiland, J., dissenting).

CONCLUSION

Certiorari should be granted to review the decision and judgment of the United States Court of Appeals for the Second Circuit.

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Respectfully submitted,

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